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TAX CONVENTION WITH THE UNITED KINGDOM (T. DOC. 107–19) AND PROTOCOLS AMENDING TAX CONVENTIONS WITH AUSTRALIA (T. DOC. 107–20) AND MEXICO (T. DOC. 108–3)

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WEDNESDAY, MARCH 5, 2003

U.S. SENATE,
COMMITTEE ON FOREIGN RELATIONS,
Washington, DC.

The committee met, pursuant to notice, at 3 p.m. in room SD–419, Dirksen Senate Office Building, Hon. Chuck Hagel presiding.

Present: Senators Hagel and Bill Nelson.

Senator HAGEL. Good afternoon. The committee meets today to consider a bilateral tax treaty between the United States and the United Kingdom as well as tax protocols with Mexico and Australia. The United States has established a network of tax treaties to bring order to our business and investment relationships with other nations. Agreements such as the three before us are an important tool for U.S. companies doing business abroad and for the U.S. Treasury. These treaties help protect U.S. taxpayers from double taxation and establish a framework to prevent individuals and companies from evading their tax obligations.

Tax treaties create a vital incentive for encouraging foreign trade and investment. We live in a world where countries and cultures are interconnected as never before. As we build on those relationships and expand trade, it is vital that our international tax policy change in order to reflect U.S. economic policies.

I am pleased to have before the committee three agreements that do just that. The U.S.-U.K. tax treaty replaces the existing agreement from 1975. While not setting a global precedent, it represents the first time that a U.S. treaty has contained a zero rate of withholding tax on dividends. The U.K. treaty contains an anti-treaty-shopping provision which will help ensure payment of taxes by multilateral corporations. It will create incentives for other nations to come to the negotiating table to work out similar agreements.

Under the treaty, citizens of the United States and United Kingdom will also benefit from each country recognizing the other's pension plans. The Mexico and Australia protocols amend the treaties which the United States signed in 1992 and 1982 respectively. Each protocol incorporates this new zero withholding provision into the underlying treaties, among other things. There are many other facets to the treaty and protocols before us. I look forward to hearing our witnesses discuss the agreements in more detail.

We will hear first from Barbara Angus, international tax counsel for the Department of Treasury's Office of Tax Policy. Ms. Angus is responsible for negotiating tax treaties and serves as principal legal advisor on all aspects of international tax policy matters. We are very pleased to have Ms. Angus with us this afternoon.

David Noren is legislative counsel specializing in international tax issues of the Joint Committee on Taxation, and David, we are glad you are with us as well, and an old friend of this committee, and one who has presented testimony and whose advice we have looked to many times over on many occasions, William Reinsch, president of the National Foreign Trade Counsel—finally he has got a real job, an honest job—will testify on the treaties from a business perspective on the second panel today, so to all of our witnesses, thank you. We are grateful that you would give us some time today, so with that, Ms. Angus, please begin.

[The opening statement of Senator Hagel follows:]

OPENING STATEMENT OF SENATOR CHUCK HAGEL

Good afternoon. The committee meets today to consider a bilateral tax treaty between the United States and United Kingdom, as well as tax protocols with Mexico and Australia.

The United States has established a network of tax treaties to bring order to our business and investment relationships with other nations. Agreements such as the three before us are an important tool for U.S. companies doing business abroad and for the U.S. Treasury. These treaties help protect U.S. taxpayers from double taxation and establish a framework to prevent individuals and companies from evading their tax obligations. Tax treaties create a vital incentive for encouraging foreign trade and investment.

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There are many other facets to the treaty and protocols before us. I look forward to hearing our witnesses discuss the agreements in more detail.

Senator HAGEL. At this time I would ask that a statement submitted by Senator Lugar be included in the record.

[The prepared statement of Senator Lugar follows:]

PREPARED STATEMENT OF SENATOR RICHARD G. LUGAR

I am delighted that we are holding this hearing this afternoon. I thank the witnesses who have come before us today and Senator Hagel for chairing the hearing in his role as Chairman of the International Economic Policy, Export and Trade Promotion Subcommittee.

At a time when the committee is considering a number of monumental foreign policy challenges, the more ordinary business of diplomacy goes on. Tax treaties may not seem exciting to some observers, but at a time when our country faces serious national security questions, we cannot neglect the important business of promoting trade and closer economic cooperation worldwide.

Earlier this year I wrote about five campaigns that the United States must undertake if it hopes to win the war on terrorism. We must strengthen U.S. diplomatic capabilities; expand and globalize the Nunn-Lugar program; build alliances; reinvigorate our commitment to democracy, the environment, energy and development; and promote free trade. Trade is one of the essential components of winning the war against terrorism because it strengthens the economic ties that bind nations together and enhances the standard of living for people around the world.

This goal will be accomplished through bold initiatives, like the comprehensive round of negotiations taking place at the World Trade Organization. But it also will be accomplished through painstaking negotiations to lower barriers to trade and investment one country at a time.

The tax treaties that we have before us today will bolster the economic relationships between the United States and three countries that are already good friends and critical trade and investment partners. In 2001, cross border investment between the United States and the United Kingdom stood at nearly half a trillion dollars. Investment between the United States and Mexico and the United States and Australia each stood at just under 60 billion dollars. By integrating and simplifying our systems of taxation, we will create an even better environment for trade and investment.

These treaties represent our most ambitious attempt yet to integrate our systems. Eliminating withholding taxes on the payment of dividends by an 80 percent owned corporation to its foreign parent corporation should greatly facilitate the flow of capital to its most beneficial uses. More than 2,500 U.S. companies have subsidiaries in the United Kingdom, Mexico, or Australia that could benefit from this change.

The reciprocal recognition of pension contributions provided for in the UK treaty is particularly important in an increasingly globalized world. This provision will allow employees to continue making tax-free contributions to retirement plans while they are working overseas, which removes a significant barrier to the cross-border provision of services. The services sector is extremely important to the U.S. economy, and it is one of the few sectors in which we hold a trade surplus with the rest of the world. There are 300,000 Americans crossing the Atlantic every year to work in the United Kingdom, and this provision, I believe, will encourage even more.

In conclusion, reporting out these tax treaties would fulfill an important role of the committee and would be an important step in promoting free trade. The last time the committee reported out any tax treaties was in 1999, over three years ago. The fact that we are facing serious national security challenges makes it all the more important that we devote energy to expanding trade and investment. I am pleased that the committee is moving forward on these treaties, which should build even stronger ties with countries that are among our closest friends and trading partners.

Senator HAGEL. We will hear first from Barbara Angus, International Tax Counsel for the Department of the Treasury's Office of Tax Policy. Ms. Angus is responsible for negotiating tax treaties and serves as a principal legal advisor on all aspects of international tax policy matters. David Noren is Legislative Counsel specializing in international tax issues for the Joint Committee on Taxation. William Reinsch, President of the National Foreign Trade Council will testify on the treaties from a business perspective on the second panel today.

STATEMENT OF BARBARA M. ANGUS, INTERNATIONAL TAX COUNSEL, U.S. DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Ms. ANGUS. Thank you, Mr. Chairman. I appreciate the opportunity to appear today at this hearing to recommend on behalf of the administration favorable action on the income tax agreements with the U.K., Australia, and Mexico.

We are committed to eliminating unnecessary barriers to cross-border trade and investment. The primary means for eliminating tax barriers to trade and investment are bilateral tax treaties. Tax treaties provide benefits to both taxpayers and governments by setting clear rules that will govern tax matters related to trade and investment between the two countries.

A tax treaty is intended to mesh the tax systems of the two countries in such a way that there is little potential for dispute regarding the amount of the tax that should be paid to each country. The goal is to ensure that taxpayers do not end up caught in the middle between two governments, each of which would like to tax the same dollar of income. We believe these three agreements, which update important treaty relationships with the U.K., Australia, and Mexico, would provide significant benefits to the United States and to our treaty partners as well as our respective business communities.

Our treaty relationships with these three countries employ a range of mechanisms to accomplish the objective of reducing the instances where taxes stand as a barrier to cross-border investment. These agreements provide certainty to taxpayers with respect to the threshold question of when the taxpayer's cross-border activities will subject it to taxation in the other country. They protect taxpayers from potential double taxation through the allocation of taxing rights between the countries. They reduce excessive taxation by reducing withholding taxes that are imposed on gross income rather than net income.

Finally, these agreements include comprehensive provisions addressing treaty shopping concerns. Preventing exploitation of our treaties by residents of third countries is critical to ensuring that the third country will sit down at the table with us to negotiate benefits and reductions in tax on a reciprocal basis, so that we can secure for U.S. persons the benefits of reductions in the third country's tax for investments there.

Before briefly describing the key provisions of these agreements with the U.K., Australia, and Mexico, I would like to discuss a development common to all three agreements. U.S. tax policy for many years has been to eliminate withholding taxes on interest and royalties, providing for exclusive residence country taxation of this income. By contrast, the U.S. regularly reduces by treaty the withholding taxes on dividends, but has never agreed in a treaty to eliminate withholding taxes on intercompany dividends. These three agreements each include provisions eliminating withholding taxes and providing for exclusive residence country tax on intercompany dividends if certain conditions are satisfied. The Treasury believes that this is an appropriate development in light of our overall treaty policy of reducing tax barriers to cross-border investment, and in the context of these three treaty relationships.

Reductions in foreign withholding taxes borne by U.S. taxpayers result in a direct benefit to the U.S. fisc to the extent that the U.S. taxpayer otherwise would have been able to use the foreign tax credit associated with such foreign taxes to offset its U.S. tax. Reductions in foreign withholding taxes results in a direct benefit to the U.S. taxpayer to the extent that the taxpayer could not have used the foreign tax credits to reduce its U.S. tax because of applicable limits. In those cases, a reduction in foreign withholding taxes represents a dollar-for-dollar reduction in its overall tax burden. The reduction in foreign withholding taxes thus represents a reduction in costs for U.S. taxpayers, increasing their competitiveness in connection with international business opportunities.

On the other hand, the imposition of U.S. withholding taxes on foreign taxpayers with investments in the U.S. represents a cost that reduces the return on those U.S. investments. Eliminating the U.S. withholding tax by treaty results in a short-term reduction in U.S. tax revenues which is offset by the increase in tax revenues associated with the reduction in foreign withholding taxes imposed on U.S. taxpayers. However, eliminating these U.S. withholding taxes on foreigners encourages inbound investment. Increased investment in the United States means more jobs, greater productivity, and higher wage rates.

Eliminating withholding taxes on dividends by treaty can serve to eliminate one of the remaining significant barriers to cross-border investment. We believe it is in the interests of the United States to consider this step in appropriate cases. We do not intend this as a blanket change in policy, because it may not be appropriate to agree to such reductions in every treaty with every country. We should be flexible, and approach each case individually.

Some key parameters apply across the board. We do not believe it is appropriate to eliminate source country tax on intercompany dividends by treaty unless the treaty contains anti-treaty-shopping rules that meet the highest standards and unless the information exchange provisions of the treaty are sufficient to allow us to confirm that the requirements for entitlement to this benefit are satisfied.

In addition to these conditions, we must be satisfied with the overall balance of the treaty. The optimal treatment of withholding taxes on intercompany dividends should be considered in the context of each treaty relationship. Let me touch briefly on the highlights of each of these three agreements.

The proposed treaty with the U.K. replaces the existing treaty, and generally follows the pattern of other recent U.S. treaties. A significant impetus for renegotiation of the U.K. tax treaty was the impact on the treaty of changes made by the U.K. to its domestic laws regarding dividends. The current treaty contains unusual rules intended to extend to U.S. shareholders the benefit of the U.K.'s treatment of dividends while dividing the cost of that benefit between the two governments. Changes in the U.K.'s domestic system for taxing dividends mean that the provisions no longer work as intended. The proposed treaty thus eliminates the provision of the existing treaty that obligates the U.S. to provide a foreign tax credit for phantom dividend withholding taxes.

The start of negotiations also provided an opportunity to bring the treaty into greater conformity with U.S. tax treaty policy. The current treaty does not include an effective anti-treaty-shopping provision, and it grants a waiver of the U.S. insurance excise tax without the anti-abuse protection that has become the standard in other U.S. treaties. The proposed treaty has been improved through the inclusion of a comprehensive limitation on benefits provision, and the addition of an anti-abuse rule that will prevent companies in third countries that do not benefit from a waiver of the U.S. insurance excise tax from using the U.K. as a conduit to avoid that U.S. tax. There were barriers to the operation of the information exchange provisions of the current treaty, and these problems have been resolved.

The maximum withholding tax rates on investment income in the proposed treaty are the same or lower than those in the existing treaty. Although the treaty continues the rule under which the country of source may tax direct investment dividends and portfolio dividends at maximum rates of 5 and 15 percent respectively, the proposed treaty provides for the elimination of withholding taxes on dividends from certain 80-percent-owned corporate subsidiaries, and on dividends derived by pension plans. The proposed treaty, like the existing treaty, provides for the elimination of source country tax on interest and royalties.

The proposed treaty also contains rules to coordinate the two countries' regimes for the tax treatment of pensions and pension contributions. These rules are more comprehensive than those in recent U.S. treaties and in the existing U.S.-U.K. treaty.

The proposed protocol to the treaty with Australia was negotiated to bring that treaty, concluded in 1982, up to date and into closer conformity with the current U.S. tax treaty practice. The most important aspects of the proposed protocol with Australia deal with the taxation of cross-border dividend royalty, and interest payments. The current treaty provides for levels of source country tax that are substantially higher than the preferred U.S. position. We were able to negotiate substantial reductions with respect to all three categories.

The proposed protocol reduces the maximum rate of tax on dividends in certain cases from the 15 percent of the current treaty to 10 percent. The proposed protocol also provides for the elimination of withholding taxes on certain intercompany dividends. Australia imposes a withholding tax on dividends paid out of earnings that have not been subject to full corporate tax, so this elimination of the withholding tax will apply to certain dividends from Australian companies.

The proposed protocol provides for the elimination of withholding taxes on interest payments in two key cases; interest derived by a financial institution and interest paid to government entities. The proposed protocol also reduces the maximum level of withholding tax on royalty payments from 10 percent, as in the current treaty, down to 5 percent. The changes in the treatment of royalties represent a major concession by Australia, which has never agreed in a treaty to lower its withholding tax on royalties below 10 percent.

The proposed treaty brings the existing treaty's treatment of income from the operation of ships, aircraft, and containers in international traffic closer to that of the U.S. model. The proposed protocol also contains an updated version of the comprehensive limitation on benefits article designed to deny treaty shoppers the benefits of the treaty.

And finally, let me touch briefly on Mexico. The proposed protocol to the income tax treaty with Mexico also was negotiated to bring the existing treaty into closer conformity with current U.S. policy. The major feature of the proposed protocol with Mexico is the treatment of intercompany dividends. As in the two prior agreements, the proposed protocol eliminates source country withholding taxes on dividends from certain 80-percent-owned subsidiaries. Dividends paid to qualified pension funds also will be exempt from withholding tax at source. While Mexico does not currently impose a withholding tax on dividends, it has enacted such a tax and then repealed it since the existing treaty was negotiated in the early 1990s. As a result, locking in this elimination of withholding taxes on intercompany dividends will provide greater certainty to U.S. taxpayers regarding the long-term tax environment for their investments in Mexico.

We urge the committee to take prompt and favorable action on these three agreements. These agreements are evidence of how even good treaty relationships can be made better. These agreements will strengthen and expand our economic relations with countries that have been significant economic and political partners for many years, and will help to further reduce barriers to cross-border trade and investment.

Let me conclude by expressing our appreciation for the hard work of the staffs of this committee and of the Joint Committee on Taxation during the tax treaty process. Thank you.

[The prepared statement of Ms. Angus follows:]

PREPARED STATEMENT OF BARBARA ANGUS, INTERNATIONAL TAX COUNSEL, UNITED STATES DEPARTMENT OF THE TREASURY

Mr. Chairman and distinguished Members of the Committee, I appreciate the opportunity to appear today at this hearing to recommend, on behalf of the Administration, favorable action on three income tax agreements that are pending before this Committee. We appreciate the Committee's interest in these agreements as demonstrated by the scheduling of this hearing.

This Administration is dedicated to eliminating unnecessary barriers to cross-border trade and investment. The primary means for eliminating tax barriers to trade and investment are bilateral tax treaties. Tax treaties eliminate barriers by providing greater certainty to taxpayers regarding their potential liability to tax in the foreign jurisdiction; allocating taxing rights between the two jurisdictions so that the taxpayer is not subject to double taxation; by reducing the risk of excessive taxation that may arise because of high gross-basis withholding taxes; and by ensuring that taxpayers will not be subject to discriminatory taxation in the foreign jurisdiction. The international network of over 2000 bilateral tax treaties has established a stable framework that allows international trade and investment to flourish. The success of this framework is evidenced by the fact that the millions of cross-border transactions that take place around the world each year give rise to relatively few disputes regarding the allocation of tax revenues between governments.

The Administration believes that these three agreements, which update important treaty relationships with the United Kingdom, Australia and Mexico, would provide significant benefits to the United States and to our treaty partners, as well as our respective business communities. We request the Committee and the Senate to take prompt and favorable action on all three agreements.

PURPOSES AND BENEFITS OF TAX TREATIES

Tax treaties provide benefits to both taxpayers and governments by setting out clear ground rules that will govern tax matters relating to trade and investment between the two countries. A tax treaty is intended to mesh the tax systems of the two countries in such a way that there is little potential for dispute regarding the amount of tax that should be paid to each country. The goal is to ensure that taxpayers do not end up caught in the middle between two governments, each of which would like to tax the same income. Once a treaty relationship is in place and working as it should, governments need expend little additional resources negotiating to resolve individual cases because the general principles for taxation of cross-border transactions and activities will have been agreed in the treaty.

One of the primary functions of tax treaties is to provide certainty to taxpayers with respect to the "threshold" question—that is, whether the taxpayer's cross-border activities will subject it to taxation by two or more countries. Treaties answer this question by establishing the minimum level of economic activity that a resident of one country must engage in within the other country before the latter country may tax any resulting business profits. In general terms, tax treaties provide that if the branch operations have sufficient substance and continuity, the country where the activities occur will have primary (but not exclusive) jurisdiction to tax. In other cases, when the operations are relatively minor, the home country retains the sole jurisdiction to tax its residents. In the absence of a tax treaty, a U.S. company operating a branch or division or providing services in another country might be subject to income tax in both the United States and the other country on the income generated by such operations. Although the United States generally provides a credit against U.S. tax liability for foreign taxes paid, there remains potential for resulting double taxation that could make an otherwise attractive investment opportunity unprofitable, depriving both countries of the benefits of increased cross-border investment.

Tax treaties protect taxpayers from potential double taxation through the allocation of taxing rights between the two countries. This allocation takes several forms. First, the treaty has a mechanism for determining the residence of a taxpayer that otherwise would be a resident of both countries. Second, with respect to each category of income, the treaty assigns the "primary" right to tax to one country, usually (but not always) the country in which the income arises (the "source" country), and the "residual" right to tax to the other country, usually (but not always) the country of residence of the taxpayer. Third, the treaty provides rules for determining which country will be treated as the source country for each category of income. Finally, the treaty establishes both limitations on the amount of tax that the source country can impose on each category of income and the obligation of the residence country to eliminate double taxation that otherwise would arise from the exercise of concurrent taxing jurisdiction by the two countries.

As a complement to these substantive rules regarding allocation of taxing rights, treaties provide a mechanism for dealing with disputes or questions of application that arise after the treaty enters into force. In such cases, designated tax authorities of the two governments—known as the Acompetent authorities@ in tax treaty parlance—are to consult and reach an agreement under which the taxpayer's income is allocated between the two taxing jurisdictions on a consistent basis, thereby preventing the double taxation that might otherwise result. The U.S. competent authority under our tax treaties is the Secretary of the Treasury. That function has been delegated to the Director, International (LMSB) of the Internal Revenue Service.

In addition to reducing potential double taxation, treaties also reduce "excessive" taxation by reducing withholding taxes that are imposed at source. Under U.S. domestic law, payments to non-U.S. persons of dividends and royalties as well as certain payments of interest are subject to withholding tax equal to 30 percent of the gross amount paid. Most of our trading partners impose similar levels of withholding tax on these types of income. This tax is imposed on a gross, rather than net, amount. Because the withholding tax does not take into account expenses incurred in generating the income, the taxpayer frequently will be subject to an effective rate of tax that is significantly higher than the tax rate that would be applicable to net income in either the source or residence country. The taxpayer may be viewed, therefore, as having suffered "excessive" taxation.

Tax treaties alleviate this burden by providing maximum levels of withholding tax that the treaty partners may impose on these types of income. In general, U.S. tax treaty policy is to reduce the rate of withholding tax on interest and royalties to zero, so that such payments are taxed exclusively in the country of residence and not in the country of source. In contrast, U.S. tax treaties have allowed some source-country taxation of dividends, with many U.S. treaties providing for a maximum source-country withholding tax of 5 percent on dividends paid to direct corporate investors and a maximum source-country withholding tax of 15 percent on dividends paid to all other shareholders. Over the years, U.S. treaty negotiators have considered proposals to treat intercompany dividends in the same manner as interest and royalties and therefore to provide for exclusive residence-country taxation of intercompany dividends in some cases. The three treaties before the Committee are the first U.S. tax treaties to do so.

Our tax treaties also include provisions intended to ensure that cross-border investors do not suffer discrimination in the application of the tax laws of the other country. While this is similar to a basic investor protection provided in several types of agreements, the non-discrimination provisions of tax treaties are more effective because they are specifically tailored to tax concerns. They provide guidance about what "national treatment" means in the tax context by specifically prohibiting types of discriminatory measures that once were common in some tax systems. At the same time, they clarify the manner in which discrimination is to be tested in the tax context. Particular rules are needed here, for example, to reflect the fact that foreign persons that are subject to tax in the host country only on certain income may not be in the same position as domestic taxpayers that may be subject to tax in such country on all their income.

Treaties also include provisions dealing with more specialized situations. Some of these provisions are becoming increasingly important as the number of individuals engaged in cross-border activities increases. For example, provisions coordinating the pension rules of the tax systems of the two countries are needed to ensure that individuals who are expecting in their retirement to be subject to a certain manner and level of taxation do not find their pensions eaten into by unexpected taxation by another country. Other quite specific rules address the treatment of employee stock options, Social Security benefits, and alimony and child support in the cross-border context. While these subjects may not involve a lot of revenue from the perspective of the two governments, rules providing clear and appropriate treatment can be very important to each of the individual taxpayers who are affected.

Other treaty provisions deal with the administration of the treaty and, to a certain extent, the domestic tax law of the two countries. One of the most important of these is the provision addressing the exchange of information between the tax authorities. Under tax treaties, the competent authority of one country may provide to the other competent authority such information as may be necessary for the proper administration of that country's tax laws, subject to strict protections on the confidentiality of taxpayer information. Because access to information from other countries is critically important to the full and fair enforcement of the U.S. tax laws, information exchange is a priority for the United States in its tax treaty program. If a country has bank secrecy rules that would prevent or seriously inhibit the appropriate exchange of information under a tax treaty, we will not conclude a treaty with that country. In fact, information exchange is a matter we raise with the other country before commencement of formal negotiations because it is one of a very few matters that we consider non-negotiable.

TREATY PROGRAM AND NEGOTIATION PRIORITIES

The United States has a network of 56 bilateral income tax treaties, the oldest of which currently in force now dates from 1950. This network includes all 29 of our fellow members of the OECD and covers the vast majority of foreign trade and investment of U.S. companies.

The Treasury Department is working to renegotiate our older tax treaties to ensure that they reflect current U.S. tax treaty policy. The treaties before you are evidence of how even good treaty relationships can be made better. At the same time, we are actively working to establish new treaty relationships that will fill gaps in our treaty network.

In establishing priorities, our primary objective is the conclusion of treaties or protocols that will provide the greatest benefits to the United States and to U.S. taxpayers. We communicate regularly with the U.S. business community, seeking input regarding the areas in which treaty network expansion and improvement efforts should be focused and information regarding practical problems they face with respect to the application of particular treaties and the application of the tax regimes of particular countries.

The U.S. commitment to including comprehensive provisions designed to prevent "treaty-shopping" in all of our tax treaties is one of the keys to improving our overall treaty network. Our tax treaties are intended to provide benefits to residents of the United States and residents of the particular treaty partner on a reciprocal basis. The reductions in source-country taxes agreed to in a particular treaty mean that U.S. persons pay less tax to that country on income from their investments there and residents of that country pay less U.S. tax on income from their investments in the United States. Those reductions and benefits are not intended to flow to residents of a third country. If third-country residents can exploit one of our treaties to secure reductions in U.S. tax, the benefits would flow only in one direction. Such use of treaties is not consistent with the balance of the deal negotiated. Moreover, preventing this exploitation of our treaties is critical to ensuring that the third country will sit down at the table with us to negotiate benefits and reductions in tax on a reciprocal basis, so that we can secure for U.S. persons the benefits of reductions in source-country tax on their investments in that country.

Treaty-shopping can take a number of forms, but it generally involves a resident of a third country that either has no treaty with the United States or has a treaty that offers relatively less benefit. The third-country resident establishes an entity in a treaty partner that has a relatively more favorable treaty with the United States in order to hold title to the resident's investments in the United States, which could range from portfolio stock investments to substantial operating subsidiaries. By interposing the new entity so that the U.S. investment appears to be made through the treaty partner, the third-country resident is able to withdraw the returns from the U.S. investment subject to the favorable rates of tax provided in the tax treaty, rather than the higher rates that would be imposed on such returns if the person had held the U.S. investments directly.

If treaty-shopping is allowed to occur, then there is less incentive for the third country with which the United States has no treaty (or has a treaty that does not reflect our preferred positions on reductions in source-country withholding taxes) to negotiate a tax treaty with the United States. The third country could maintain inappropriate barriers to investment and trade from the United States and yet its companies could obtain the benefits of lower U.S. tax by organizing their investment and trade in the United States so that they flow through a country with a favorable tax treaty with the United States.

For these reasons, all recent U.S. tax treaties contain comprehensive "limitation on benefits" provisions that limit the benefits of the treaty to bonafide residents of the treaty partner. These provisions are not uniform, as each country has particular characteristics that affect both its attractiveness as a country through which to treaty shop and the mechanisms through which treaty shopping may be attempted. Consequently, the specific limitation on benefits provision in each treaty must to some extent be tailored to fit the facts and circumstances of the treaty partner's internal laws and practices. Moreover, the provisions need to strike a balance that prevents the inappropriate exploitation of treaty benefits while ensuring that the treaty benefits floss smoothly to the legitimate and desirable economic activity for which the benefits were intended.

Despite the protections of the limitation on benefits provisions, there may be countries with which we choose not to have a tax treaty because of the possibility of abuse. With other countries there may not be the type of cross-border tax issues that are best resolved by treaty. For example, we generally do not conclude tax treaties with jurisdictions that do not impose significant income taxes, because there is little possibility of double taxation of income in such a case. In such cases, an agreement focused on the exchange of tax information can be very valuable in furthering the goal of reducing U.S. tax evasion.

The situation is more complex when a country adopts a special preferential regime for certain parts of the economy that is different from the rules generally applicable to the country's residents. In those cases, the residents benefiting from the preferential regime do not face potential double taxation and so should not be entitled to reductions in U.S. withholding taxes, while a treaty relationship might be useful and appropriate in order to avoid double taxation in the case of the residents who do not receive the benefit of the preferential regime. Accordingly, in some cases we have treaty relationships that carve out certain residents and activities from the benefits of the treaty. In other cases, we have determined that economic relations with the relevant country were such that the potential gains from a treaty were not sufficient to outweigh the risk of abuse, and have therefore decided against entering into a tax treaty relationship (or have terminated an existing relationship).

Prospective treaty partners must indicate that they understand their obligations under the treaty, including those with respect to information exchange, and must demonstrate that they are able to comply with those obligations. Sometimes a potential treaty partner is unable to do so. In other cases we may feel that a treaty is inappropriate because the potential treaty partner may be unwilling to address in the treaty real tax problems identified by U.S. businesses operating there. Lesser developed and newly emerging economies, for which capital and trade flows with the United States are often disproportionate or virtually one-way, may not be willing to reduce withholding taxes to a level acceptable to the United States because of concerns about the short-term effects on tax revenues.

The primary constraint on the size of our tax treaty network, however, may be the complexity of the negotiations themselves. The various functions performed by tax treaties, and particularly the goal of meshing two different tax systems, make the negotiation process exacting and time consuming. While the starting point for all U.S. tax treaty negotiations is the U.S. Model Tax Convention, it is never the ending point.

A country's tax policy, as reflected in its domestic tax legislation as well as its tax treaty positions, reflects the sovereign choices made by that country. Numerous features of the treaty partner's unique tax legislation and its interaction with U.S. domestic tax rules must be considered in negotiating an appropriate treaty. Examples include whether the country eliminates double taxation through an exemption or a credit system, the country's treatment of partnerships and other transparent entities, and how the country taxes contributions to pension funds, the funds themselves, and distributions from the funds. A treaty negotiation must take into account all of these and many other aspects of the treaty partner's tax system in order to arrive at an acceptable treaty from the perspective of the United States. Accordingly, a simple side-by-side comparison of two treaties, or of a proposed treaty against a model treaty, will not enable meaningful conclusions to be drawn as to whether a proposed treaty reflects an appropriate balance. Moreover, there may be differences that are of little substantive importance, reflecting language issues, cultural obstacles or other impediments to the use of particular U.S. or other model text.

Each treaty is the result of a negotiated bargain between two countries that often have conflicting objectives. Each country has certain positions that it considers non-negotiable. The United States, which insists on effective anti-treaty-shopping and exchange of information provisions, and which must accommodate its uniquely complex tax laws, probably has more non-negotiable positions than most countries. For example, every U.S. treaty must contain the Asaving clause@, which permits the United States to tax its citizens and residents as if the treaty had not come into effect, and allow the United States to apply its rules applicable to former citizens and long-term residents. Other U.S. tax law provisions that may complicate negotiations are the branch profits tax and the branch level interest tax, rules regarding contingent interest, real estate mortgage investment conduits, real estate investment trusts and regulated investment companies, and the Foreign Investors in Real Property Tax Act rules.

Obtaining the agreement of our treaty partners on provisions of importance to the United States sometimes requires other concessions on our part. Similarly, other countries sometimes must make concessions to obtain our agreement on matters that are critical to them. In most cases, the process of give-and-take produces a document that is the best treaty that is possible with that other country. In others, we may reach a point where it is clear that it will not be possible to reach an acceptable agreement. In those cases, we simply stop negotiating with the understanding that negotiations might restart if circumstances change. Accordingly, each treaty that we present here represents not only the best deal that we believe we can achieve with the particular country at this time, but also constitutes an agreement that we believe is in the best interests of the United States.

DISCUSSION OF TREATIES AND PROTOCOLS

I would now like to discuss the importance and purposes of each agreement that has been transmitted for your consideration. We have submitted Technical Explanations of each agreement that contain detailed discussions of the provisions of each treaty and protocol. These Technical Explanations serve as an official Treasury Department guide to each agreement. Before discussing the individual treaties, however, I would like to discuss a development common to all three agreements.

Elimination of Source Country Tax on Certain Intercompany Dividends

As discussed above, U.S. tax treaty policy for many years has been to eliminate (or when that is not possible, to substantially reduce) source-country withholding taxes on interest and royalties. By contrast, the United States regularly reduces by treaty the withholding tax on intercompany dividends but has never agreed in a treaty to eliminate source-country withholding taxes on intercompany dividends. These three agreements each include provisions eliminating source-country withholding taxes on intercompany dividends if certain conditions are satisfied. Treasury believes that this is an appropriate development in light of our overall treaty policy of reducing tax barriers to cross-border investment and in the context of these three treaty relationships.

Bilateral reductions in source-country withholding taxes have two offsetting effects on U.S. tax revenues in the short term. Reductions in the U.S. withholding taxes imposed on foreign persons with investments in the United States represent a short-term static reduction in U.S. tax revenues. On the other hand, reductions in foreign withholding taxes imposed on U.S. persons with foreign investments represent a short-term static increase in tax revenues for the United States because the U.S. persons that pay less in foreign withholding taxes therefore claim less in foreign tax credits to offset their U.S. tax liability. When U.S. companies receive more in payments from their foreign subsidiaries than U.S. subsidiaries make in payments to their foreign parents, the reduction in foreign tax credit claims will offset the reduction in withholding tax collections. This should hold true with respect to dividends, as U.S. companies receive significantly more direct dividends from abroad than foreign companies receive from the United States.

Reductions in foreign withholding taxes borne by U.S. taxpayers result in a direct benefit to the U.S. fisc to the extent that the U.S. taxpayer otherwise would have been able to use the foreign tax credits associated with such withholding taxes to offset its U.S. tax liability. Reductions in foreign withholding taxes result in a direct benefit to the U.S. taxpayer to the extent that the taxpayer could not have used the foreign tax credits to offset its U.S. tax liability because of applicable limitations of domestic law. In cases where the U.S. taxpayer has excess foreign tax credits, a reduction in foreign withholding taxes represents a dollar-for-dollar reduction in its overall tax burden: The reduction in foreign withholding taxes thus represents a reduction in costs that may increase competitiveness in connection with international business opportunities.

For example, if a U.S. company is considering an investment in a foreign country, it of course must consider the after-tax cost of that investment. If the potential investment is the purchase of an existing business in a foreign country, the U.S. company likely will compete against bidders from other countries. If the U.S. company is in an excess foreign tax credit position, any withholding tax paid to the host country will decrease the U.S company's expected return on the foreign investment. If another bidder is not subject to the host country withholding tax (perhaps because of its home country's treaty relationship with the host country), it may be willing to pay a higher price for the target.

Similarly, a foreign company that is in an excess foreign tax credit position in its home country might be discouraged from investing in the United States because of the five percent withholding tax that the United States is permitted to impose on direct investment dividends under most of its tax treaties. The same is true of a company that is based in a country that relieves double taxation by exempting direct investment dividends from taxation. In either case, the imposition of a five percent U.S. withholding tax reduces the return on the investment in the United States dollar-for-dollar. Eliminating the withholding tax by treaty therefore may encourage inbound investment. Increased investment in the United States means more jobs, greater productivity and higher wage rates.

The historical U.S. position of not eliminating by treaty withholding taxes on direct investment dividends was consistent with general treaty practice throughout the world. When most major trading partners imposed such a tax, then the tax would not create the competitive advantages and disadvantages described above, since every company would be subject to it. In addition, many of our treatys were negotiated at a time when corporate tax rates in Europe tended to be higher than those in the United States, making it less likely for foreign companies to be in an excess foreign tax credit position. As a result, a five percent U.S. withholding tax on direct investment may not have been seen as a significant cost of doing business here. However, more and more countries are eliminating their withholding taxes on intercompany dividends. In this regard, it should be noted that the Parent-Subsidiary Directive adopted by the European Union in 1990 eliminated all withholding taxes on dividends paid by a subsidiary in one EU member country to a parent in another of the fifteen (soon to be 25) members of the European Union. Moreover, corporate tax rates have been falling around the world. In this climate, it was appropriate for the United States to consider agreeing by treaty to eliminate source-country withholding taxes on certain intercompany dividends.

We believe that it is in the interest of the United States to take a flexible approach, agreeing to eliminate the withholding tax on intercompany dividends in appropriate cases. This would not be a blanket change in policy, and the Treasury Department does not recommend a change to the U.S. negotiating position in this respect, because it may not be appropriate to agree to such reductions in every treaty with every country. Therefore, we would approach each case individually.

Some key parameters apply across the board. We do not believe that it is appropriate to eliminate source-country taxation of intercompany dividends by treaty unless the treaty contains anti-treaty-shopping rules that meet the highest standards and the information exchange provision of the treaty is sufficient to allow us to confirm that the requirements for entitlement to this benefit are satisfied. Strict protections against treaty shopping are particularly important when the elimination of withholding taxes on intercompany dividends is included in relatively few U.S. treatys.

In addition to these conditions, we must be satisfied with the overall balance of the treaty. This assessment will be relatively simple in cases where the other country imposes a withholding tax on dividends comparable to the U.S. withholding tax and the dividend flows are roughly equal (or favor the United States). In other cases, eliminating withholding taxes on intercompany dividends nevertheless may be appropriate if the United States benefits from concessions made by the other country with respect to other provisions of the treaty. As with many treaty elements, it is a matter of balance. Finally, there may be cases where the elimination of withholding taxes by treaty is desirable from the U.S. perspective in order to lock in a treaty partner whose domestic law regarding withholding taxes may be in flux and to establish certainty and stability with respect to the tax treatment of investments in a particular country. We do not believe that we should attempt now to set all the parameters for when elimination of source-country withholding taxes on intercompany dividends is appropriate and when it is not. The optimal treatment of source-country withholding taxes on intercompany dividends must be considered in the context of each treaty relationship.

United Kingdom

The proposed Convention with the United Kingdom was signed in London on July 24, 2001, and was amended by a Protocol, signed in Washington on July 19, 2002. The Convention is accompanied by an exchange of diplomatic notes, also dated July 24, 2001. The Convention, Protocol and notes replace the existing Convention, which was signed in London in 1975 and modified by subsequent notes and protocols. The proposed Convention generally follows the pattern of other recent U.S. treaties and the U.S. Model treaty.

A significant impetus for the re-negotiation of the U.S.-U.K. tax treaty was the impact on the operation of the treaty of changes made by the United Kingdom to its domestic laws regarding the treatment of dividends. The dividend article of the current treaty (along with corresponding provisions of the article regarding foreign tax credits) contains unusual rules intended to extend to U.S. shareholders the benefit of the United Kingdom's imputation system for the taxation of dividends, while dividing the cost of that benefit between the United States and the United Kingdom. Changes in the United Kingdom's domestic system for taxing dividends mean that the provisions no longer work as intended.

The start of negotiations also provided an opportunity to bring the treaty into greater conformity with U.S. tax treaty policy. The current treaty does not include an effective anti-treaty-shopping provision, and it grants a waiver of the insurance excise tax without the anti-abuse protection that has become standard in other U.S. tax treaties. There were substantial problems under the information exchange provisions of the current treaty because the United Kingdom could obtain information for the United States only if it too needed the information for its own domestic tax purposes. Moreover, because the treaty was negotiated in the late 1970's, it did not include any of the provisions that are included in modern treaties to reflect the changes in U.S. domestic law made over the last 20 years.

The maximum withholding tax rates on investment income in the proposed Convention are the same or lower than those in the existing treaty. Although the Convention continues the rule under which the country of source may tax direct investment dividends and portfolio dividends at a maximum rate of 5 and 15 percent, respectively, the proposed Convention provides for a withholding rate of zero percent on dividends from certain 80-percent-owned corporate subsidiaries and those derived by pension plans. The proposed Convention was the first income tax treaty signed by the United States that contains this elimination of source-country tax for intercompany dividends.

Dividends paid by non-taxable conduit entities, such as U.S. regulated investment companies and real estate investment trusts, and any comparable investment vehicles in the United Kingdom, are subject to special rules to prevent the use of these entities to obtain withholding rate reductions that would not otherwise be available.

The proposed Convention, like the existing treaty and the U.S. Model, provides for the elimination of source-country tax on interest and royalties. Excess inclusions with respect to residual interests in U.S. real estate mortgage investment conduits may be taxed under U.S. domestic rules, without regard to the rest of the provisions relating to interest, and contingent interest may be taxed by the source country at a maximum rate of 15 percent rate.

The proposed Convention confirms that the United States generally will not impose the excise tax on insurance policies issued by foreign insurers if the premiums on such policies are derived by a U.K. enterprise. This rule is a continuation of the waiver of the excise tax that applies under the existing Convention. However, the proposed Convention has been improved through the addition of an anti-abuse rule that will prevent companies in third countries that do not benefit from a waiver of the insurance excise tax from using a U.K. insurance company as a conduit to avoid imposition of the tax.

The proposed Convention provides for exclusive residence-country taxation of profits from the operation in international traffic of ships or aircraft, including profits from the rental of ships and aircraft on a full basis, or on a bareboat basis if the rental income is incidental to profits from the operation of ships or aircraft in international traffic. All income from the use, maintenance or rental of containers used in international traffic is likewise exempt from source-country taxation under the proposed Convention.

The proposed Convention carries over from the existing treaty special rules regarding offshore exploration and exploitation activities. These rules were included at the request of the United Kingdom. The proposed Convention reflects technical changes to avoid some unintended consequences of the old rules and provides a slightly higher threshold for taxation of employees working in the offshore oil sector.

The proposed Convention contains rules to coordinate the two countries' regimes for the tax treatment of pensions and pension contributions. These rules are more comprehensive than those in recent U.S. treaties and the existing Convention. Under the proposed Convention, the United States and the United Kingdom each will treat pension plans established in the other State the same way comparable domestic plans are treated. A similar rule applies to earnings and accretions of pension plans and to employer contributions to pension plans. In addition, the proposed Convention provides for the exclusive residence-based taxation of Social Security payments, which is different from the U.S. Model but consistent with the existing Convention.

The proposed Convention also deals with income earned by entertainers and sportsmen, corporate directors, government employees and students in a manner consistent with the rules of the U.S. Model. The Convention continues a host-country exemption for income earned by teachers that is found in the existing treaty, although not in the U.S. Model.

The proposed Convention contains comprehensive rules in its "Limitation on Benefits" article, designed to deny "treaty-shoppers" the benefits of the Convention. This article is essentially the same as the limitation on benefits articles contained in recent U.S. treaties.

At the request of the United Kingdom, the proposed Convention includes an additional limit on the availability of certain treaty benefits obtained in connection with "conduit arrangements." The conduit arrangement test may apply to deny treaty benefits in certain tax avoidance cases involving the payment of insurance premiums, dividends, interest, royalties, or other income. The conduit arrangement test is not contained in the U.S. Model. The test is designed primarily to allow the United Kingdom to address treaty shopping transactions that would not be caught by the limitation on benefits article of the proposed Convention. U.K. domestic law does not provide sufficient protection against such abusive transactions, but U.S. domestic law does. The tax authorities of the two countries have agreed on an interpretation of the term "conduit arrangement" that is consistent with existing tax avoidance doctrines and measures under U.S. law.

The proposed Convention provides relief from double taxation in a manner consistent with the U.S. Model and eliminates the provision of the existing treaty that obligates the United States to provide a foreign tax credit for "phantom" dividend withholding taxes. The proposed Convention also contains a re-sourcing rule to ensure that a U.S. resident can obtain a U.S. foreign tax credit for U.K. taxes paid when the Convention assigns to the United Kingdom primary taxing rights over an item of gross income. A comparable rule applies for purposes of the U.K. foreign tax credit. Although the U.S. Model does not contain a re-sourcing rule, the existing Convention contains a similar rule.

Like the existing treaty, the proposed Convention provides a credit for the U.K. Petroleum Revenue Tax, limited to the amount of the tax attributable to sources within the United Kingdom. The credit allowed by the proposed Convention is somewhat broader than that allowed under the existing Convention to account for intervening changes in U.S. domestic law.

The proposed Convention provides for non-discriminatory treatment (i.e., national treatment) by one country to residents and nationals of the other. Also included in the proposed treaty are rules necessary for administering the treaty, including rules for the resolution of disputes under the Convention. The information exchange provisions generally follow the U.S. Model and make clear that the United Kingdom will provide U.S. tax officials such information as is relevant to carry out the provisions of the Convention and the domestic tax laws of the United States. Inclusion of this U.S. Model provision was made possible by a recent change in U.K. law.

Australia

The proposed Protocol to the Income Tax Convention with Australia was signed in Canberra on September 27, 2001. It was negotiated to bring the current Convention, concluded in 1982, up to date and into closer conformity with current U.S. tax treaty practice, while also incorporating some provisions found in the Australian Model income tax convention.

The most important aspects of the proposed Protocol deal with the taxation of cross-border dividend, royalty and interest payments. The current treaty provides for levels of source-country taxation that are consistent with Australian treaty practice but substantially higher than the preferred U.S. position. We were able to negotiate substantial reductions with respect to all three categories of payments.

Whereas the existing Convention allows for taxation at source of 15 percent on all dividends, the proposed Protocol provides for a maximum source-country withholding tax rate of 5 percent on direct dividends that meet a 10 percent ownership threshold. The proposed Protocol also provides for the elimination of the source-country withholding taxes with respect to dividends from certain 80 percent owned corporate subsidiaries. Portfolio dividends will continue to be subject to a 15 percent rate of withholding. Australia imposes a withholding tax on dividends paid out of earnings that have not been subject to full corporate tax ("unfranked dividends"), which will be eliminated under the proposed Protocol.

Dividends paid by U.S. regulated investment companies and real estate investment trusts are subject to special rules to prevent the use of these entities to obtain withholding rate reductions that would not otherwise be available. The provision was adapted to recognize the special investment structure of Australian unit trusts and their participation in the U.S. REIT industry.

The proposed Protocol provides for the elimination of source-country withholding taxes on interest payments in two key cases. Interest derived by a financial institution that is unrelated to the payor and interest paid to governmental entities are exempt from withholding tax at source.

All other types of interest (including interest received by financial institutions in back-to-back loans or their economic equivalent) continue to be subject to source-country withholding tax at the 10 percent maximum rate prescribed in the existing Convention.

The proposed Protocol also reduces the maximum level of withholding tax on royalty payments from the 10 percent limit prescribed in the existing Convention to 5 percent. The existing Convention treats rental payments for the use of or the right to use any industrial, commercial or scientific equipment as royalties that may be taxed by the source country at a maximum rate of 10 percent. The proposed Protocol eliminates the source-country withholding tax on such income by treating this category of income as business profits. These changes in the treatment of royalties represent a major concession by Australia, which has never agreed in a treaty to lower its withholding tax on royalties below 10 percent.

The proposed Protocol brings the existing Convention's treatment of income from the operation of ships, aircraft and containers in international traffic closer to that of the U.S. Model. The proposed Protocol provides for exclusive residence-country taxation of profits from the rental of ships and aircraft on a bareboat basis when the rental activity is incidental to the operation in international traffic of ships or aircraft by the lessor. All income from the use, maintenance or rental of containers used in international traffic is likewise exempt from source-country taxation under the proposed Protocol.

The proposed Protocol clarifies that Australia's tax on capital gains will be a covered tax for purposes of the existing Convention. This closes a gap in the existing Convention and increases the likelihood that U.S. taxpayers subject to capital gains tax in Australia will be able to claim a foreign tax credit with respect to that tax thereby avoiding potential double taxation. The proposed Protocol generally preserves the existing Convention's tax treatment of capital gains, while incorporating some aspects of Australia's domestic law regarding expatriation. The proposed Protocol also provides rules that coordinate both countries' tax systems with respect to these expatriation rules.

The proposed Protocol contains an updated version of a comprehensive "Limitation on Benefits" article, designed to deny "treaty-shoppers" the benefits of the Convention. This article is essentially the same as the limitation on benefits article contained in recent U.S. treaties.

The current Convention preserves the U.S. right to tax former citizens whose loss of citizenship had as one of its principal purposes the avoidance of tax. The proposed Protocol expands this right to include former long-term residents whose loss of such status had, as one of its principal purposes, the avoidance of tax. Therefore, the United States may fully apply the provisions of section 877 of the Internal Revenue Code.

Mexico

The proposed Protocol to the Income Tax Convention with Mexico was signed in Mexico City on November 26, 2002. It was negotiated to bring the existing Convention, concluded in 1992, into closer conformity with current U.S. tax treaty policy.

The major feature of the proposed Protocol is the treatment of intercompany dividends. As in the agreements with the United Kingdom and Australia, the proposed Protocol eliminates source-country withholding taxes on certain types of cross-border direct dividends. Under the existing Convention, dividends may be taxed by the country of source at a maximum rate of 5 percent on direct dividends (where the recipient of the dividends owns at least 10 percent of the company paying the dividends) and 10 percent with respect to all other dividends. The proposed Protocol eliminates withholding taxes with respect to dividends from certain 80-percent owned corporate subsidiaries. The other rules will remain in place with respect to those dividends that do not qualify for the elimination of the source-country withholding tax. Dividends paid to qualified pension funds also will be exempt from withholding tax at source.

While Mexico does not currently impose a withholding tax on dividends, it has enacted such a tax and then repealed it since the existing treaty was negotiated in the early 1990's. As a result, locking in the elimination of source-country withholding taxes on intercompany dividends will provide greater certainty to U.S. taxpayers regarding the long-term tax environments for their investments in Mexico.

Dividends paid by U.S. regulated investment companies and real estate investment trusts are subject to special rules to prevent the use of these entities to obtain withholding rate reductions that would not otherwise be available.

The current treaty preserves the U.S. right to tax former citizens whose loss of citizenship had as one of its principal purposes the avoidance of tax. The proposed Protocol expands this right to include former long-term residents whose loss of such status had, as one of its principal purposes, the avoidance of tax. Therefore, the United States may fully apply the provisions of section 877 of the Internal Revenue Code.

The proposed Protocol incorporates a modernized provision regarding the source of income that will be more effective in eliminating double taxation. Under the new provision, income that may be taxed by one of the parties to the Convention will generally be treated as arising in that country. Thus, the other country generally will exempt that income or provide a credit for the taxes paid with respect to such income.

TREATIES UNDER NEGOTIATION

We continue to maintain an active calendar of tax treaty negotiations. We are in active negotiations with Japan, the Netherlands, Iceland, Hungary, Barbados, France, Bangladesh, Canada, and Korea. We have also signed an agreement with Sri Lanka which we expect will be ready for transmittal to the Senate soon. In accordance with the treaty program priorities noted earlier, we continue to seek appropriate opportunities for tax treaty discussions and negotiations with several countries in Latin America and in the developing world generally.

CONCLUSION

Let me conclude by again thanking the Committee for its continuing interest in the tax treaty program, and the Members and staff for devoting the time and attention to the review of the agreements that are pending before you. We also appreciate the assistance and cooperation of the staffs of this Committee and of the Joint Committee on Taxation in the tax treaty process.

We urge the Committee to take prompt and favorable action on the three agreements before you today. Such action will strengthen and expand our economic relations with countries that have been significant economic and political partners for many years and will help to further reduce barriers to cross-border trade and investment.

[Attachments.]

DEPARTMENT OF THE TREASURY,
Washington, DC, July 19, 2002.

GABRIEL MAKHLOUF, *Director*
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DEAR MR. MAKHLOUF:

As we have discussed, questions have been raised about the manner in which our respective tax examiners will administer the rules in our proposed income tax convention dealing with "conduit arrangements". We hope that an exchange of letters will provide useful guidance regarding the position in each country.

With respect to the United States, we intend to interpret the conduit arrangement provisions of the Convention in accordance with U.S. domestic law as it may evolve over time. The relevant law currently includes in particular the rules of regulation section 1.881-3 and other regulations adopted under the authority of section 7701(1) of the Internal Revenue Code. Therefore, the inclusion of the conduit arrangement rules in the Convention does not constitute an expansion (or contraction) of U.S. domestic anti-abuse principles (except with respect to the application of anti-conduit principles to the insurance excise tax).

We understand that the United Kingdom does not have domestic law provisions relating to conduit transactions. It has, however, entered into a number of treaties which include provisions aimed at dealing with conduit-type arrangements. We understand that the United Kingdom will, subject to the limitations in Article 3(1)(n), interpret the provisions in the proposed convention in a manner consistent with its practice under those other treaties.

In practice, of course, such general principles and practice will be applied to particular fact patterns in determining whether the anti-conduit provisions will apply. In order to further develop our mutual understanding of how we each propose to apply the language, I have set out below a number of examples together with the U.S. view regarding whether benefits would be denied in each case.

We would appreciate your views, including the reasoning behind your conclusion, regarding the treatment that would apply to each of the cases set out below if the situation were reversed and the United Kingdom were the source of the payments.

I look forward to your response regarding the U.K. views of these transactions (as reversed). I appreciate the opportunity for our teams to work together on this important matter.

Very truly yours,

BARBARA M. ANGUS,
International Tax Counsel.

Annex

Example 1. UKCo, a publicly traded company organized in the United Kingdom, owns all of the outstanding stock of USCo. XCo, a company organized in a country that does not have a tax treaty with the United States, would like to purchase a minority interest in USCo, but believes that the 30% U.S. domestic withholding tax on dividends would make the investment uneconomic. UKCo proposes that USCo instead issue preferred stock to UKCo, paying a fixed return of 4% plus a contingent return of 20% of USCo's net profits. The maturity of the preferedpreferred stock is 20 years. XCo will enter into a separate contract with UKCo pursuant to which it pays to UKCo an amount equal to the issue price of the preferred stock and will receive from UKCo after 20 years the redemption price of the stock. During the 20 years, UKCo will pay to XCo 3⅔% plus 20% of USCo's net profits.

This arrangement constitutes a conduit arrangement because UKCo participated in the transaction in order to achieve a reduction in U.S. withholding tax for XCo.

Example 2. USCo has issued only one class of stock, common stock that is 100% owned by UKCo, a company organized in the United Kingdom. UKCo also has only one class of common stock outstanding, all of which is owned by XCo, a company organized in a country that does not have a tax treaty with the United States. UKCo is engaged in the manufacture of electronics products, and USCo serves as UKCo's exclusive distributor in the United States, Under paragraph 4 of Article 23 (Limitation on Benefits), UKCo will be entitled to benefits with respect to dividends received from USCo, even though UKCo is owned by a resident of a third country.

Because the common stock owned by UKCo and XCo does not represent a "financing transaction" within the meaning of regulation section 1.881-3 as currently in effect, on these facts, this will not constitute a conduit arrangement.

Example 3. XCo, a company organized in a country that does not have a tax treaty with the United States, loans $1,000,000 to USCo, its wholly-owned U.S. subsidiary in exchange for a note issued by USCo. XCo later realizes that it can avoid the U.S. withholding tax by assigning the note to its wholly-owned subsidiary, UKCo. Accordingly, XCo assigns the note to UKCo in exchange for a note issued by UKCo. The USCo note pays 7% and the UKCo note pays 6¾%.

The transaction constitutes a conduit arrangement because it was structured to eliminate the U.S. withholding tax that XCo otherwise would have paid.

Example 4. XCo, a company organized in Country X, which does not have a tax treaty with the United States, owns all of the stock of USCo, a company resident in the United States. XCo has for a long time done all of its banking with UKCo, a company organized in the United Kingdom, because the banking system in Country X is relatively unsophisticated. As a result, XCo tends to maintain a large deposit with UKCo. UKCo is unrelated to XCo and USCo. When USCo needs a loan to fund an acquisition, XCo suggests that USCo deal with UKCo, which is already familiar with the business conducted by XCo and USCo. USCo discusses the loan with several different banks, all on terms similar to those offered by UKCo, but eventually enters into the loan with UKCo, in part because interest paid to UKCo would not be subject to U.S. withholding tax, while interest paid to banks organized in Country X would be.

The United States will consider the fact that UKCo is unrelated to USCo and XCo in determining whether there is a conduit arrangement. Accordingly, this will be treated as a conduit arrangement only if UKCo would not have entered into the transaction on substantially the same terms in the absence of the XCo deposit. Under these facts, there is no conduit arrangement.

Example 5. UKCo, a publicly-traded company organized in the United Kingdom, is the holding company for a manufacturing group in a highly competitive technological field. The manufacturing group conducts research in subsidiaries located around the world. Any patents developed in a subsidiary are licensed by the subsidiary to UKCo, which then licenses the technology to its subsidiaries that need it. UKCo keeps only a small spread with respect to the royalties it receives, so that most of the profit goes to the subsidiary that incurred the risk with respect to developing the technology. XCo, a company located in a country with which the United States does not have a tax treaty, has developed a process that will substantially increase the profitability of all of UKCo's subsidiaries, including USCo, a company organized in the United States. According to its usual practice, UKCo licenses the technology and sub-licenses the technology to its subsidiaries. USCo pays a royalty to UKCo, substantially all of which is paid to XCo.

Because UKCo entered into these transactions in the ordinary course of its business, and there is no indication that it established its licensing business in order to reduce its U.S. withholding tax, the arrangements among USCo, UKCo and XCo do not constitute a conduit arrangement.

Example 6. XCo is a publicly traded company resident in Country X, which does not have a tax treaty with the United States. XCo is the parent of a world wide group of companies, including UKCo, a company resident in the United Kingdom, and USCo, a company resident in the United States. USCo is engaged in the active conduct of a trade or business in the United States. UKCo is responsible for coordinating the financing of all of the subsidiaries of XCo. UKCo maintains a centralized cash management accounting system for XCo and its subsidiaries in which it records all intercompany payables and receivables. UKCo is responsible for disbursing or receiving any cash payments required by transactions between its affiliates and unrelated parties. UKCo enters into interest rate and foreign exchange contracts as necessary to manage the risks arising from mismatches in incoming and outgoing cash flows. The activities of UKCo are intended (and reasonably can be expected) to reduce transaction costs and overhead and other fixed costs. UKCo has 50 employees, including clerical and other back office personnel, located in the United Kingdom.

XCo lends to UKCo DM 15 million (worth $10 million) in exchange for a 10-year note that pays interest annually at a rate of 5% per annum. On the same day, UKCo lends $10 million to USCo in exchange for a 10-year note that pays interest annually at a rate of 8% per annum. UKCo does not enter into a long-term hedging transaction with respect to these financing transactions, but manages the interest rate and currency risk arising from the transactions on a daily, weekly or quarterly basis by entering into forward currency contracts.

Because UKCo performs significant activities with respect to the transactions between USCo and XCo, the participation of UKCo is presumed not to have as one of its main purposes the avoidance of U.S. withholding tax. Accordingly, based upon the foregoing facts, the loan from XCo to UKCo and the loan from UKCo to USCo do not constitute a conduit arrangement under the Convention.

INLAND REVENUE INTERNATIONAL DIVISION,
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1500 Pennsylvania Avenue, NW,
Washington, DC.

DEAR BARBARA,

Thank you for your letter of 19 July. I am happy to confirm that your understanding of the UK's position with regard to the application of the rules in our proposed income tax treaty dealing with "conduit arrangements" is correct.

I attach the examples, reversed to show the position where income flows from the UK to the US, together with our views on how we would apply the anti-conduit rules to the transactions described.

Annex

Example 1. USCo, a publicly traded company organised in the United States, owns all of the outstanding stock of UKCo. XCo, a company organised in a country that does not have a tax treaty with the United Kingdom, would like to purchase a minority interest in UKCo. USCo proposes that UKCo issue preferred stock to USCo, paying a fixed return of 4% plus a contingent return of 20% of UKCo's net profits. The maturity of the preferred stock is 20 years. XCo will enter into a separate contract with USCo pursuant to which it pays to USCo an amount equal to the issue price of the preferred stock and will receive from USCo after 20 years the redemption price of the stock. During the 20 years, USCo will pay to XCo 3¾% plus 20% of UKCo's net profits.

The U.K. considers this arrangement would meet the objective definition of a conduit arrangement at Article 3(1)(n)(i) but because the U.K. has no withholding tax on dividends the motive test at Article 3(1)(n)(ii) would not be met because no increased treaty benefit would be obtained by the routing through the U.S. Therefore the arrangement would not constitute a conduit arrangement as defined by the treaty.

Example 2. UKCo has issued only one class of stock, common stock that is 100% owned by USCo, a company organized in the United States. USCo also has only one class of common stock outstanding, all of which is owned by XCo, a company organized in a country that does not have a tax treaty with the United Kingdom. USCo is engaged in the manufacture of electronics products, and UKCo serves as USCo's exclusive distributor in the United Kingdom. Under paragraph 4 of Article 23 (Limitation on Benefits), USCo will be entitled to benefits with respect to dividends received from UKCo, even though USCo is owned by a resident of a third country.

This seems to be a perfectly acceptable and normal commercial structure with real economic activity in both the U.S. and the U.K. The payment of dividends by subsidiary companies is a normal feature of commercial life. Accordingly, in the absence of evidence that dividends were flowed through to XCo, these transactions would not constitute a conduit arrangement.

Example 3. XCo, a company organized in a country that does not have a tax treaty with the United Kingdom, loans $1,000,000 to UKCo, its wholly-owned U.K. subsidiary in exchange for a note issued by UKCo. XCo later realizes that it can avoid the U.K. withholding tax by assigning the note to its wholly-owned subsidiary, USCo. Accordingly, XCo assigns the note to USCo in exchange for a note issued by USCo. The UKCo note pays 7% and the USCo note pays 6¾%.

The loan note was assigned to avoid U.K income tax on the payment of interest. The transaction constitutes a conduit arrangement as defined in the treaty as both the objective definition and the motive test at Article 3(1)(n)(i) and (ii) respectively are met.

Example 4. XCo, a company organized in Country X, which does not have a tax treaty with the United Kingdom, owns all of the stock of UKCo, a company resident in the United Kingdom. XCo has for a long time done all of its banking with USCo, a company organized in the United States, because the banking system in Country X is relatively unsophisticated. As a result, XCo tends to maintain a large deposit with USCo. USCo is unrelated to XCo and UKCo. When UKCo needs a loan to fund an acquisition, XCo suggests that UKCo deal with USCo, which is already familiar with the business conducted by XCo and UKCo. UKCo discusses the loan with several different banks, all on terms similar to those offered by USCo, but eventually enters into the loan with USCo, in part because interest paid to USCo would not be subject to U.K. withholding tax, while interest paid to banks organized in Country X would be.

The fact that UK/US treaty benefits are available if UKCo borrows from USCo, and that similar benefits might not be available if it borrowed elsewhere, is clearly a factor in UKCo's decision (which may be influenced by advice given to by its 100% shareholder). It may even be a decisive factor, in the sense that, all else being equal, the availability of treaty benefits may swing the balance in favour of borrowing from USCo rather than from another lender. However, whether the obtaining of treaty benefits was "the main purpose or one of the main purposes" of the transaction would have to be determined by reference to the particular facts and circumstances.

Similarly, for the anti-conduit provision to apply it would have to be established that the interest paid by UKCo was “flowing through” USCo to XCo. The fact that XCo has historically maintained large deposits with USCo might, if anything, be a counter-indication. Against that, there is the question why a cash-rich company would want to increase its overall debt exposure in this way. XCo could redirect its balance with USCo and lend it to UKCo—in which case it would face U.K. withholding tax. It chooses not to, so there is a possible argument that the transactions were structured to avoid U.K. withholding tax by obtaining benefits under the treaty.

On the specific facts as presented, the transactions would not constitute a conduit arrangement as defined by the treaty.

However, if USCo’s decision to lend to UKCo was dependent on XCo providing a matching collateral deposit to secure the loan, the indication would be that XCo was in substance lending to UKCo direct but in form routing the loan through a bank with whom it has a close relationship in order to obtain the benefit of the treaty. In such circumstances the transactions would constitute a conduit arrangement as defined by the treaty.

Example 5. USCo, a publicly-traded company organized in the United States, is the holding company for a manufacturing group in a highly competitive technological field. The manufacturing group conducts research in subsidiaries located around the world. Any patents developed in a subsidiary are licensed by the subsidiary to USCo, which then licenses the technology to its subsidiaries that need it. USCo keeps only a small spread with respect to the royalties it receives, so that most of the profit goes to the subsidiary that incurred the risk with respect to developing the technology. XCo, a company located in a country with which the United Kingdom does not have a tax treaty, has developed a process that will substantially increase the profitability of all of USCo’s subsidiaries, including UKCo, a company organized in the United Kingdom. According to its usual practice, USCo licenses the technology and sub-licenses the technology to its subsidiaries. UKCo pays a royalty to USCo, substantially all of which is paid to XCo.

Because XCo is conforming to the standard commercial organisation and behaviour of the group in the way that it structures its licensing and sub-licensing activities and assuming the same structure is employed with respect to other subsidiaries carrying out similar activities in countries which have treaties which offer similar or more favourable benefits, the inference would be that the absence of a treaty between country X and the U.K. is not influencing the motive for the transactions described.

Therefore even though the specific fact pattern, as presented, meets the first part of the definition of a “conduit arrangement” at Article 3(1)(n)(i), on balance the conclusion would be that “the main purpose or one of the main purposes” of the transactions was not the obtaining of UK/US treaty benefits. So the structure would not constitute a conduit arrangement.

Example 6. XCo is a publicly traded company resident in Country X, which does not have a tax treaty with the United Kingdom. XCo is the parent of a worldwide group of companies, including USCo, a company resident in the United States, and UKCo, a company resident in the United Kingdom. UKCo is engaged in the active conduct of a trade or business in the United Kingdom. USCo is responsible for coordinating the financing of all of the subsidiaries of XCo. USCo maintains a centralized cash management accounting system for XCo and its subsidiaries in which it records all inter-company payables and receivables. USCo is responsible for disbursing or receiving any cash payments required by transactions between its affiliates and unrelated parties. USCo enters into interest rate and foreign exchange contracts as necessary to manage the risks arising from mismatches in incoming and outgoing cash flows. The activities of USCo are intended (and reasonably can be expected) to reduce transaction costs and overhead and other fixed costs. USCo has 50 employees, including clerical and other back office personnel, located in the United States.

XCo lends to USCo DM 15 million (worth $10 million) in exchange for a 10-year note that pays interest annually at a rate of 5% per annum. On the same day, USCo lends $10 million to UKCo in exchange for a 10-year note that pays interest annually at a rate of 8% per annum. USCo does not enter into a long-term hedging transaction with respect to these financing transactions, but manages the interest rate and currency risk arising from the transactions on a daily, weekly or quarterly basis by entering into forward currency contracts.

UKCo appears to be a real business performing substantive economic functions, using real assets and assuming real risks. USCo appears to be bearing the interest rate and currency risk. It is assumed that the transactions are typical of USCo’s normal treasury business and that that business was carried on in a commercial manner.

So, on the specific facts presented, the transactions would not constitute a conduit arrangement as defined by the treaty.

Senator HAGEL. Ms. Angus, thank you very much.

Mr. Noren.

STATEMENT OF DAVID NOREN, LEGISLATION COUNSEL, JOINT COMMITTEE ON TAXATION, U.S. CONGRESS, WASHINGTON, DC

Mr. NOREN. Thank you, Mr. Chairman. It is my pleasure to present the testimony of the staff of the Joint Committee on Taxation today concerning the proposed income tax treaty with the United Kingdom and the proposed protocols to the existing income tax treaties with Australia and Mexico.

As in the past, the Joint Committee staff has prepared pamphlets covering the proposed treaty and protocols. The pamphlets provide detailed descriptions of the provisions of the proposed treaty and protocols, including comparisons with the 1996 U.S. model income tax treaty, which reflects preferred U.S. treaty policy, and with other recent U.S. tax treaties. The pamphlets also provide detailed discussions of issues raised by the proposed treaty and protocols.

We consulted with the Department of the Treasury and with the staff of your committee in analyzing the proposed treaty and protocols, and in preparing the pamphlets. My testimony today will highlight some of the key features of the proposed treaty and protocols and certain issues that they raise.

One new feature of the proposed treaty and protocols is the zero rate of withholding tax on certain intercompany dividends provided under all three instruments. These provisions do not appear in the U.S. model treaty, or in any existing U.S. treaty, and their inclusion in the proposed treaty and protocols represents a significant development in U.S. tax treaty practice.

These provisions would eliminate source country withholding tax on cross-border dividends paid by one corporation to another corporation that owns at least 80 percent of the stock of the dividend-paying corporation, provided that certain conditions are met. Under the current treaties with the United Kingdom and Mexico, these dividends may be subject to withholding tax at a rate of 5 percent. Under the current treaty with Australia, these dividends may be subject to withholding tax at a rate of 15 percent. The elimination of the withholding tax under these circumstances is intended to further reduce the tax barriers to direct investment between the United States and these treaty partners.

Although no existing U.S. treaty provides for a complete exemption from withholding tax under these circumstances, many bilateral treaties to which the United States is not a party do eliminate withholding taxes under similar circumstances. The same result has been achieved within the European Union by E.U. directive. Thus, although these zero-rate provisions are unprecedented in U.S. treaty history, there is substantial precedent for them in the experience of other countries.

Looking beyond the three treaty relationships directly at issue, the committee may wish to determine whether the inclusion of zero-rate provisions in the proposed treaty and protocols signals a broader shift in U.S. tax treaty policy. Specifically, the committee may want to know whether and under what circumstances the Department of the Treasury intends to pursue similar provisions in other treaties, and whether the U.S. model treaty will be amended to reflect these developments.

The proposed treaty with the United Kingdom is a comprehensive update of the 1975 treaty. The provisions of the proposed treaty are generally consistent with the U.S. model treaty. While the zero-rate provision is of particular interest, the proposed treaty includes several other key features. The proposed treaty includes a comprehensive anti-treaty-shopping provision which resembles the provisions of the U.S. model treaty and other recent treaties. The existing treaty with the United Kingdom, like other treaties of its era, does not include a comprehensive anti-treaty-shopping provision.

The proposed treaty also includes an extensive set of rules designed to coordinate the pension plans and other retirement arrangements provided under the laws of the two countries. These rules would facilitate retirement planning using the tax-favored vehicles available under U.S. and U.K. law in cases involving individuals who live for some period of time in both countries.

The proposed treaty includes a general anti-conduit rule that can operate to deny the benefits of several articles of the treaty. This rule is not found in any other U.S. treaty, and it is not included in the U.S. model. The rule is similar to, but significantly narrower and more precise than, the "main purpose" rules that the Senate rejected in 1999 in connection with its consideration of the proposed U.S.-Italy and U.S.-Slovenia treaties. The rule was included at the request of the United Kingdom, which has similar provisions in many of its tax treaties.

The purpose of the rule, from the U.K. perspective, is to prevent residents of third countries from improperly obtaining the reduced rates of U.K. tax provided under the treaty by channeling payments to a third country resident through a U.S. resident. From the U.S. perspective, the rule is generally unnecessary, because U.S. domestic law provides detailed rules governing arrangements to reduce U.S. tax through the use of conduits.

The proposed treaty also raises issues with respect to the waiver of the U.S. insurance excise tax, the treatment of dividend substitute payments, the attribution of profits to permanent establishments, the treatment of shipping income, the creditability of the U.K. petroleum revenue tax for purposes of the U.S. foreign tax credit, and the treatment of visiting teachers, all of which are discussed in detail in the Joint Committee staff pamphlet on the proposed treaty.

The proposed protocol with Australia makes several modifications to the 1982 treaty. The provisions of the proposed protocol are generally consistent with the U.S. model treaty. The proposed protocol reduces source country withholding tax rates under the existing treaty with respect to dividends, interest, and royalties.

In addition to adopting the zero-rate provision for certain intercompany dividends, the modified dividends provision also provides a maximum withholding tax rate of 5 percent on dividends meeting a 10-percent ownership threshold, consistent with the U.S. model. In other cases, the 15-percent rate of the existing treaty is maintained, also consistent with the U.S. model.

With respect to interest, the proposed protocol continues to allow source country withholding tax at a rate of 10 percent, but generally allows a zero rate for interest received by financial institutions and governmental entities. The U.S. model does not allow source country withholding tax with respect to interest.

The proposed protocol also retains source country taxation of royalties under the existing treaty, but reduces the maximum level of withholding tax from 10 percent to 5 percent. In addition, the proposed protocol amends the definition of royalties to remove equipment leasing income, thus eliminating the withholding tax on this income and rendering it taxable by the source country only if the recipient has a permanent establishment in that country. The U.S. model does not allow source country withholding tax with respect to royalties.

The proposed protocol also amends the shipping income provisions under the existing treaty to reflect more closely the treatment of such income under the U.S. model treaty.

The proposed protocol with Mexico makes several modifications to the 1992 treaty, but the adoption of the zero-rate dividends provision is the principal change and was the impetus behind the protocol. Under the existing treaty, if the United States adopts a withholding tax rate on dividends lower than 5 percent in another treaty, the United States and Mexico have agreed to promptly amend their treaty to incorporate that lower rate. The inclusion of zero-rate dividends provisions in the proposed treaty with the United Kingdom and the proposed protocol with Australia would trigger this obligation, and the inclusion of the provision in the proposed protocol with Mexico is responsive to it.

These provisions and issues are all discussed in more detail in the Joint Committee staff pamphlets on the proposed treaty and protocols.

I would be happy to answer any questions that the committee may have at this time or in the future. Thank you.

[The prepared statement of the staff of the Joint Committee on Taxation follows:]

PREPARED STATEMENT OF THE STAFF OF THE JOINT COMMITTEE ON TAXATION,[1] PRESENTED BY DAVID NOREN, LEGISLATION COUNSEL, JOINT COMMITTEE ON TAXATION

My name is David Noren. I am Legislation Counsel to the Joint Committee on Taxation. It is my pleasure to present the testimony of the staff of the Joint Committee on Taxation (the "Joint Committee staff") today concerning the proposed income tax treaty with the United Kingdom and the proposed protocols to the existing income tax treaties with Australia and Mexico.

[1] This document may be cited as follows: Joint Committee on Taxation, *Testimony of the Staff of the Joint Committee on Taxation Before the Senate Committee on Foreign Relations Hearing on a Proposed Tax Treaty with the United Kingdom and Proposed Protocols to Tax Treaties with Australia and Mexico* (JCX-14-03), March 3, 2003.

[1] Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty Between the United States and the United Kingdom* (JCS-4-03), March 3, 2003, at 73-74.

OVERVIEW

As in the past, the Joint Committee staff has prepared pamphlets covering the proposed treaty and protocols. The pamphlets provide detailed descriptions of the provisions of the proposed treaty and protocols, including comparisons with the 1996 U.S. model income tax treaty, which reflects preferred U.S. treaty policy, and with other recent U.S. tax treaties. The pamphlets also provide detailed discussions of issues raised by the proposed treaty and protocols. We consulted with the Department of the Treasury and with the staff of your Committee in analyzing the proposed treaty and protocols and in preparing the pamphlets.

The proposed treaty with the United Kingdom would replace an existing treaty signed in 1975. The proposed protocol with Australia would make several modifications to an existing treaty signed in 1982. The proposed protocol with Mexico would make several modifications to an existing treaty signed in 1992.

My testimony will highlight some of the key features of the proposed treaty and protocols and certain issues that they raise.

"ZERO-RATE" DIVIDEND PROVISIONS

One new feature of the proposed treaty and protocols is the "zero rate" of withholding tax on certain intercompany dividends provided under all three instruments. These provisions do not appear in the U.S. model treaty or in any existing U.S. treaty, and their inclusion in the proposed treaty and protocols represents a significant development in U.S. tax treaty practice.

These provisions would eliminate source-country withholding tax on cross-border dividends paid by one corporation to another corporation that owns at least 80 percent of the stock of the dividend-paying corporation, provided that certain conditions are met. Under the current treaties with the United Kingdom and Mexico, these dividends may be subject to withholding tax at a rate of 5 percent. Under the current treaty with Australia, these dividends may be subject to withholding tax at a rate of 15 percent. The elimination of the withholding tax under these circumstances is intended to further reduce the tax barriers to direct investment between the United States and these treaty partners.

Although no existing U.S. treaty provides for a complete exemption from withholding tax under these circumstances, many bilateral treaties to which the United States is not a party eliminate withholding taxes under similar circumstances. The same result has been achieved within the European Union by E.U. directive. Thus, although these zero-rate provisions are unprecedented in U.S. treaty history, there is substantial precedent for them in the experience of other countries.

Looking beyond the three treaty relationships directly at issue, the Committee may wish to determine whether the inclusion of zero-rate provisions in the proposed treaty and protocols signals a broader shift in U.S. tax treaty policy. Specifically, the Committee may want to know whether and under what circumstances the Department of the Treasury intends to pursue similar provisions in other treaties, and whether the U.S. model treaty will be amended to reflect these developments.

UNITED KINGDOM

The proposed treaty with the United Kingdom is a comprehensive update of the 1975 treaty. The provisions of the proposed treaty are generally consistent with the U.S. model treaty. While the zero-rate provision is of particular interest, the proposed treaty includes several other key features.

The proposed treaty includes a comprehensive anti-treaty-shopping provision, which resembles the provisions of the U.S. model treaty and other recent treaties. The existing treaty with the United Kingdom, like other treaties of its era, does not include a comprehensive anti-treaty-shopping provision.

The proposed treaty also includes an extensive set of rules designed to coordinate the pension plans and other retirement arrangements provided under the laws of the two countries. These rules would facilitate retirement planning using the tax-favored vehicles available under U.S. and U.K. law in cases involving individuals who live for some period of time in both countries.

The proposed treaty includes a general "anti-conduit" rule that can operate to deny the benefits of several articles of the treaty. This rule is not found in any other U.S. treaty, and it is not included in the U.S. model. The rule is similar to, but significantly narrower and more precise than, the "main purpose" rules that the Senate rejected in 1999 in connection with its consideration of the proposed U.S.-Italy and U.S.-Slovenia treaties. The rule was included at the request of the United Kingdom, which has similar provisions in many of its tax treaties. The purpose of the rule, from the U.K. perspective, is to prevent residents of third countries from improperly obtaining the reduced rates of U.K. tax provided under the treaty by channeling payments to a third-country resident through a U.S. resident. From the U.S. perspective, the rule is generally unnecessary, because U.S. domestic law provides detailed rules governing arrangements to reduce U.S. tax through the use of conduits.

The proposed treaty also raises issues with respect to the waiver of the U.S. insurance excise tax, the treatment of dividend substitute payments, the attribution of profits to permanent establishments, the treatment of shipping income, the creditability of the U.K. petroleum revenue tax under the U.S. foreign tax credit rules, and the treatment of visiting teachers, all of which are discussed in detail in the Joint Committee staff pamphlet on the proposed treaty.

AUSTRALIA

The proposed protocol with Australia makes several modifications to the 1982 treaty. The provisions of the proposed protocol are generally consistent with the U.S. model treaty.

The proposed protocol reduces source-country withholding tax rates under the existing treaty with respect to dividends, interest, and royalties. In addition to adopting the zero-rate provision for certain intercompany dividends, the modified dividends provision also provides a maximum withholding tax rate of 5 percent on dividends meeting a 10-percent ownership threshold, consistent with the U.S. model. In other cases, the 15-percent rate of the existing treaty is maintained, also consistent with the U.S. model.

With respect to interest, the proposed protocol continues to allow source-country withholding tax at a rate of 10 percent, but generally allows a zero rate for interest received by financial institutions and governmental entities. The U.S. model does not allow source-country withholding tax with respect to interest.

The proposed protocol also retains source-country taxation of royalties under the existing treaty, but reduces the maximum level of withholding tax from 10 percent to 5 percent. In addition, the proposed protocol amends the definition of royalties to remove equipment leasing income, thus eliminating the withholding tax on this income and rendering it taxable by the source country only if the recipient has a permanent establishment in that country. The U.S. model does not allow source-country withholding tax with respect to royalties.

The proposed protocol also amends the shipping income provisions under the existing treaty to reflect more closely the treatment of such income under the U.S. model treaty.

MEXICO

The proposed protocol with Mexico makes several modifications to the 1992 treaty, but the adoption of the zero-rate dividends provision is the principal change and was the impetus behind the protocol. Under the existing treaty, if the United States adopts a withholding tax rate on dividends lower than 5 percent in another treaty, the United States and Mexico have agreed to promptly amend their treaty to incorporate that lower rate. The inclusion of zero-rate dividends provisions in the proposed treaty with the United Kingdom and the proposed protocol with Australia would trigger this obligation, and the inclusion of the provision in the proposed protocol with Mexico is responsive to it.

CONCLUSION

These provisions and issues are all discussed in more detail in the Joint Committee staff pamphlets on the proposed treaty and protocols. I would be happy to answer any questions that the Committee may have at this time or in the future.

Senator HAGEL. Mr. Noren, thank you. Again, thank you each for your testimony.

Ms. Angus, your testimony is very complete, and we appreciate that very much.

Let me begin with part of Mr. Noren's testimony. In your testimony, page 2, you ask specifically, "the committee may want to know whether and under what circumstances the Department of the Treasury intends to pursue similar provisions in other treaties," referencing zero-rate provisions, and I noted in the last part of your testimony, Ms. Angus, that you reference treaties currently under negotiation, which I want to visit a little bit about.

That might be a good starting question to ask you to respond to, and you I am sure were very attentive to Mr. Noren's commentary this afternoon. Why don't we start there with his question, because I had a similar question that I wanted to ask as well, and I think you understand what his point is, so have at it. Thank you.

Ms. ANGUS. Thank you, Mr. Chairman. We believe that provisions that eliminate the withholding tax on dividends can be very beneficial. In the case of intercompany dividends, such provisions do serve to reduce what can be a significant barrier to cross-border investment, and it is something that we believe that we should consider.

Some years ago, most countries retained the right to impose a withholding tax on dividends, but more and more countries are eliminating their withholding taxes on dividends by treaty, and as Mr. Noren pointed out, the European Union has done it as well, so that dividends paid by a company in one European country to a parent in another European country are not subject to withholding tax. It is something that we believe we need to consider in order to help to eliminate these cross-border investment barriers between the U.S. and our trading partners.

That said, it is something that we need to look at very carefully, and we believe that there are some clear parameters that need to be included as we consider eliminating withholding taxes on dividends. One is a strong and effective anti-treaty-shopping provision. Also the information exchange provisions that are needed to ensure that we have access to the information to be able to test the anti-treaty-shopping provision and determine that the dividend really is being paid to someone who is resident of the other country.

That is critically important when we are talking about beginning to include a benefit in our treaties that has not traditionally been included in our treaties, because treaty shopping will be a particular concern there. As we are only beginning to include this provision, we need to be particularly vigilant about treaty shopping.

In looking at considering this elimination, we really think we need to look at the balance of benefits of the treaty, and it is something that we should consider in our existing relationships and our new treaty relationships as we go forward.

Senator HAGEL. The list of treaties under negotiation in your testimony, can you tell the committee whether you are currently looking at or intending to put zero-rate provisions in any of these?

Ms. ANGUS. It is certainly something that we are considering, and there has been significant interest from some of our treaty partners. Some of our treaty partners have policies of maintaining withholding taxes not just on dividends, but in some cases, on interest and royalties as well, and we work to try to reduce those withholding taxes. But there are other countries that have long held policies of eliminating withholding taxes on interest and royalties and that are beginning to seek to reduce them in the case of dividends as well, and so it is something that we are discussing with our treaty partners in Europe, as well as some of our other treaty partners.

There has been a great deal of interest in the inclusion of this provision in the treaties that are pending before the committee today. I know that not only are there many in the business community that are eagerly waiting to see what the reaction to these treaties is from the committee, but also there are countries around the world that are waiting to see what the reaction is.

Senator HAGEL. But none specifically that you would point out here in your list of treaties under negotiation that you focused on?

Ms. ANGUS. I think it is really hard to point to a specific country, since all of our negotiations are ongoing, and as I said, we really think this is something that we need to look at in the context of the whole balance of the treaty. As an initial matter, we need to make sure that we are able to include our preferred position on anti-treaty-shopping provisions, but beyond that, we need to make sure that the balance of benefits in the treaty is set at the optimal level. And it is fair to say that when you are negotiating any deal, no element of it is finished until it is all finished.

Senator HAGEL. All right. Thank you.

Mr. Noren, do you have any comments on this?

Mr. NOREN. The Joint Committee staff does not have a general position on the appropriateness of zero-rate dividends provisions. I think if you look at our pamphlets, we clearly are of the view that there are potentially significant benefits from doing this, arising from mitigating double taxation and further reducing barriers to cross-border investment.

The benefit of doing this is arguably amplified, given that many other countries seem to be doing it as well; conversely, the competitive disadvantage to the country if we were not to start doing this is arguably greater the more prevalent it becomes generally. I would agree with everything that Ms. Angus has said about the inability to develop a general position as to whether it is appropriate in all cases, and I think that the kinds of things she mentioned are exactly the kinds of things that we have to think about: Do we have strong anti-treaty-shopping rules with that treaty partner? Do we have strong information exchange agreements? We might want to review the tax system of the treaty partner. Does that treaty partner have a comprehensive income tax system that imposes tax at rates that are in the same ball park as the rates of our system?

So those are the kinds of things that I think we would have to think about on a case-by-case basis.

Senator HAGEL. Thank you. Staying with this flow, Ms. Angus, something that Mr. Noren just said about significant barriers created by tax systems that still remain in cross-border investment, what would you say we all need to continue to work on in that general area of significant barriers that still remain, Mr. Noren referenced, within the tax structure systems of countries?

Ms. ANGUS. Well, I think there are a number of things that we need to look to. We certainly need to continue our policy of seeking to reduce withholding taxes and seeking to get provisions in our treaties in place that do everything that they can to eliminate double taxation. There are some evolving issues that I think we will need to pay continuing attention to, and increasing attention to.

One area is the issues that arise because of developments in technology. As technology develops and enables business to further globalize their operations, more international tax issues arise that need to be addressed in the tax treaty context in order to ensure that double taxation on the activities associated with that technology is avoided.

A lot of the tax treaty concepts that have developed over the years were developed in a world that was looking at bricks-and-mortar business. As we go to a more technology-based economy and greater reliance on services, we need to make sure that the rules that we have that assign taxing rights between countries and that operate to prevent double taxation work properly in the context of what some refer to as the new economy.

Another issue that we are encountering increasingly is the issue of individuals who will spend part of their career working in one country and part working in another, or maybe in several countries over the course of their career. The proposed treaty with the U.K. includes a comprehensive set of provisions dealing with coordinating the tax treatment of pensions, both pension benefits and pension contributions, between the two countries so that an individual who throughout his career has been saving for his retirement does not find in his retirement years that his pension is being eaten up by taxation from a foreign country that he did not anticipate. We were able with the U.K. to do a very comprehensive set of provisions coordinating the pension rules because of some basic similarities between our systems, but that is something that we need to continue to look to with other countries so that taxes not only are not a barrier to movements of capital, but also are not a barrier to movements of people.

Senator HAGEL. Mr. Noren, would you have any comment on this?

Mr. NOREN. I do not have anything to add to that.

Senator HAGEL. OK, thank you.

Ms. Angus, what are your projections, and maybe you had them in here, or do you have projections on the revenue impact of the treaty and the protocols?

Ms. ANGUS. The purpose of the treaties, as we have talked about here today, is to protect taxpayers from double taxation by allocating taxing rights between the two countries, so between the United States and between our treaty partner. We also seek to avoid excessive taxation by reducing withholding taxes, including the withholding taxes on dividends that we have talked about here today.

Depending on the specific circumstances, the net effect of all of the provisions in the treaty may be a short-term revenue gain or loss when you look just in the short-term and just at tax revenues. I think the key point is that a tax treaty is a negotiated agreement under which both countries expect to be better off in the long run. We believe that treaties provide significant economic benefits to the United States, to our treaty partner, and to both of our business communities, and so we believe that the short-term revenue effects of a treaty can pale in comparison to its long-term benefits.

The treaties provide greater certainty and a more stable environment for foreign investment. They reduce tax-related barriers to cross-border investment that will allow for a more productive allocation of capital. This stability and enhanced capital flow will have positive effects on the economies of both countries.

Senator HAGEL. Thank you, Ms. Angus. Mr. Noren, would you like to respond?

Mr. NOREN. I would echo everything that Ms. Angus said and just note that traditionally Congress and the President and the Treasury Department have treated treaties as being essentially in a category of their own, as being not a part of the budget process, and so it has been the custom not to provide detailed revenue estimates of proposed treaties. As Ms. Angus says, they are negotiated agreements in which two different countries each agree to yield some of their taxing jurisdiction with a view toward achieving these larger benefits.

Senator HAGEL. Thank you. We have had some general reference to future treaties and the protocols that will continue to be required, as we are doing two of today, to adjust to the new dynamics, new challenges and as you pointed out, Ms. Angus, especially technology is changing things so rapidly that we have to try to assure that our policies are at least consistent with the reality of what the marketplace is, and all the other challenges that we are dealing with.

In that regard, would you consider the U.S.-U.K. treaty in today's 2003 terms, and maybe out a couple of years, a model for what you can use as you negotiate out these treaties you are working on now, and into the future?

Ms. ANGUS. I think in some senses it can be viewed as a model. It reflects some important developments and a lot of detailed work on dealing with some of these emerging issues, the pension issue for one. It was the first treaty that the United States signed that would eliminate the withholding tax on intercompany dividends. But the U.K. treaty is a function of the need to mesh the two particular tax systems, to mesh our tax system with the particular tax system of the U.K.

We have some common features of our systems that allowed us to mesh things sometimes more easily than may arise with other countries. That said, even with our close history with the United Kingdom, they have some aspects of their tax system that are unique and that created particular issues, so there were special rules we needed to deal with in order to mesh our system with those elements of theirs.

To be fair, our own system certainly contains a lot of rules that add to the complexity of this meshing of systems process as well. I think there are many important things in the U.K. treaty that we ought to be considering in other treaties, while keeping in mind that each treaty is intended to serve the purpose of meshing the systems of two particular countries, and to foster the economic cooperation between those two economies, and so there always will be unique provisions in any treaty relationship.

Senator HAGEL. Thank you. Mr. Noren, would you like to respond?

Mr. NOREN. The only thing I would add to that is that the Joint Committee staff, in its tax simplification study, which was released in the spring of 2001, made a recommendation that the U.S. model treaty be updated more frequently than it is. Our recommendation specifically was once per Congress, and I think that with the existing model treaty now being 7 years old, the tax treaty process might become somewhat more transparent, and congressional involvement in the process improved, with more frequent updates of the model.

Senator HAGEL. So we are not paying attention well enough up here, is your kind way to say it, Mr. Noren.

We have been joined by our friend from Florida, who knows a little something about taxes, former insurance commissioner, astronaut, all-around bon vivant, our friend the Senator from Florida, Bill Nelson. Senator Nelson.

Senator NELSON. You go on. I am learning from you.

Senator HAGEL. That is a frightening prospect, if the Senator from Florida says he is learning from me.

I mentioned, Ms. Angus, I wanted to go back to the additional treaties that you were looking at, and you mention in your testimony the Sri Lanka treaty might well be ready for transmittal to the Senate fairly soon. Is there a consistency to the current treaties that you have under negotiation that we could help you with up here, or be better prepared to deal with some of these issues?

I think Mr. Noren's point is a good one, and our staff, like any staff, is pulled in many directions here, and we never have enough time and attention, but if there are things that you could point us toward where we could be preparing ourselves maybe more effectively than we have in the past, or to assist you or just stay out of your way, then we would value that, so take any piece of that that you like.

Ms. ANGUS. Well, thank you, Mr. Chairman, we very much appreciate the assistance of this committee and the interest of this committee in tax treaties, and we very much appreciate the work of the staff of this committee. We who are focused on taxes recognize that your committee and your staff has so many other priorities and responsibilities beyond our world of taxes and tax treaties.

On the issue of the model treaty, we certainly agree with the comments about the need to make sure that we have a model that provides the guidance that it ought to provide. It is useful as a document on which to base discussions with this committee and your staffs, and it also serves to provide information to taxpayers as well, and so a model treaty is a way to disseminate that sort of information, as treaty practice evolves. Now, that said, we do need to balance the work in publishing a model with the work in negotiating new treaties, so that is always a balancing matter.

In terms of the treaties that we are negotiating currently, we have a very active schedule, and we are dealing with a range of situations, some renegotiations of existing treaties in order to modernize and update those treaties, and some situations where we are dealing with the need to address more targeted issues within a treaty, and then we have some agreements that will represent the first treaty relationship with a country. The agreement that we were able to sign recently with Sri Lanka is an example of that. That entire relationship will be our first tax treaty relationship with that country.

The issues that arise when we are looking at renegotiation of a treaty sometimes are different than with a new treaty, but in all cases, the goals are the same.

Senator HAGEL. Mr. Noren, would you like to add anything to that?

Mr. NOREN. No, Senator.

Senator HAGEL. Senator Nelson, I am going to submit some specific, more technical questions to the Treasury, just to let you know, and so I am not going to get into those now, but just to make you aware of that, and I am going to ask Senator Nelson now if he has questions or anything he would like to add.

Senator NELSON. May I ask a question?

Senator HAGEL. Yes, sir.

Senator NELSON. We do a lot of business back and forth in insurance, and I am curious, does the U.K. tax imposed on U.K. insurers and reinsurers such as a lot of activities that spin off from Lloyd's, does that U.K. tax on insurance premium income result in a burden that is substantial in relationship to the U.S. tax?

Ms. ANGUS. Senator, yes, it does. Our treaty, our current treaty with the U.K. includes a provision that waives the U.S. insurance excise tax on premiums paid to foreign insurers. The provision in the existing treaty does not have the anti-abuse rule that we prefer to see in our treaties, and that is included in our recent treaties.

So one of the significant improvements we feel we were able to make with the proposed treaty with the U.K. was to include just that sort of anti-abuse rule, an anti-conduit provision that would prevent the residents of third countries, including countries that do not have significant taxation of insurance operations, from being able to funnel their activities through the U.K. in order to get the benefit of the agreement that we have reached with the U.K.

In looking at this matter, in addition to wanting to ensure that we were able to add to what is in the existing treaty in order to have this anti-abuse rule, we also conducted a thorough review of the U.K. tax law and of information about the U.K. tax treatment of insurance, and that review demonstrated that insurance companies that are resident in the U.K. are subject to a substantial level of tax in the U.K. So that was part of our review of this provision as well.

Senator NELSON. Would one of those third parties be an example like Bermuda, that has very little taxation of any income coming in from insurance?

Ms. ANGUS. That would be an example, and that is why we thought, particularly with the size of the insurance market in the U.K., that it was critically important to update our treaty relationship to include this anti-abuse rule so that companies in other countries that have the lower tax burdens on insurance cannot take advantage of a provision in the U.K. treaty and get a reduction in U.S. tax to which they should not be entitled.

Senator NELSON. Thank you, Mr. Chairman. I appreciate it.

Senator HAGEL. Senator Nelson, thank you. Unless our two witnesses have any further comments or additional contributions, we are grateful for your testimony and your time and, as I said, we will submit additional questions. Thank you very much.

Mr. Reinsch. Well, I have introduced you once, but I will take the opportunity to introduce you again. Those of you who are familiar with this committee and economic issues, great issues of our time, know our second witness, the Hon. William Reinsch, president of the National Foreign Trade Council here in Washington, who has had many senior-level positions with our government, and we are grateful, Bill, that you would find time to spend some of that time with us today, so please proceed with your testimony.

STATEMENT OF HON. WILLIAM A. REINSCH, PRESIDENT, NATIONAL FOREIGN TRADE COUNCIL, INC., WASHINGTON, DC

Mr. REINSCH. Thank you, Mr. Chairman. It is an honor to be back. I recall the last time I was here when you were the Chair, we were discussing the effect on the domestic and commercial communications satellite industry of various congressional actions with respect to exports. I believe this is a less controversial topic, and I am pleased to be here.

Let me say I am also accompanied by Mary C. Bennett, of the law firm of Baker and McKenzie, who is the National Foreign Trade Council's [NFTC] counsel in this area, and she is going to help me answer all the hard questions. I am going to deliver an abbreviated statement in the hopes that you will put my entire statement in the record.

Senator HAGEL. Your complete statement will be in the record.

Mr. REINSCH. Thank you. The NFTC is honored to be here, and pleased to recommend ratification of the treaty and protocols under consideration by the committee today. We appreciate your action, Mr. Chairman, in scheduling this hearing so promptly, and we strongly urge the committee to reaffirm the United States' historic opposition to double taxation by giving its full support to the pending treaty and protocols.

You know who we are at the NFTC, and you know what our goals are and what we stand for. We seek to foster an environment in which U.S. companies can be dynamic and effective competitors in the international business arena. To achieve this goal, American businesses must be able to participate fully in business activities throughout the world through the export of goods, services, technology, and entertainment, and through direct investment in facilities abroad.

As global competition grows ever more intense, it is vital to the health of U.S. enterprises and to their continuing ability to contribute to the U.S. economy that they be free from excessive foreign taxes or double taxation that can serve as a barrier to full participation in the international marketplace. Tax treaties are a crucial component of the framework that is necessary to allow such balanced competition. That is why the NFTC has long supported the expansion and strengthening of the U.S. tax treaty network, and why we are here today to recommend ratification of the tax convention protocol with the U.K. and the protocols amending the tax conventions with Australia and Mexico.

It is important to note that taxpayers are not the only beneficiaries of tax treaties. Treaties protect the legitimate enforcement interest of the U.S. Treasury by providing for the exchange of information between tax authorities. Treaties have also provided a framework for the resolution of disputes with respect to overlapping claims by the respective governments.

In particular, the practices of the competent authorities under the treaties have led to agreements known as advanced pricing agreements, or APA's, through which tax authorities of the United States and other countries have been able to avoid costly and unproductive disputes over appropriate transfer prices for the trade in goods and services between related entities.

The treaty and protocols that are under your consideration today, Mr. Chairman, are a good illustration of the contribution such agreements can make to improving both the economic competitiveness of U.S. companies and the proper administration of U.S. tax laws in the international arena.

For example, the U.K., Australian, and Mexican agreements contain a provision new to U.S. treaty policy which calls for a zero rate of withholding tax on dividends paid to parent corporations from their 80 percent or greater owned subsidiaries. The existing of a withholding tax on cross-border parent-subsidiary dividends, even at the 5 percent rate previously typical in U.S. treaties, has served as a tariff-like barrier to cross-border investment flows.

Without a zero rate, the combination of the underlying corporate tax and the withholding tax on the dividend will often lead to unusable excess foreign tax credits in the parent's hands, resulting in a lower return from a cross-border investment than from a comparable domestic investment. This sort of multiple taxation of profits within a corporate group leads to exactly the kind of distortion in investment decisions that tax treaties are meant to prevent.

If U.S. businesses are going to maintain a competitive position around the world, we need a treaty policy that protects us from multiple or excessive levels of foreign tax on our cross-border investments, particularly if our competitors already enjoy that advantage.

The United States has lagged behind other developed countries in eliminating this withholding tax and leveling the playing field for cross-border investment. For example, the European Union eliminated this tax on intra-E.U. parent-subsidiary dividends over a decade ago, and dozens of bilateral treaties between foreign countries have also followed that route. The majority of OECD countries now have bilateral treaties in place that provide for a zero rate on parent-subsidiary dividends.

The NFTC has for years urged Treasury to change U.S. treaty policy to allow for this zero rate on dividends, and we highly commend Treasury for taking the first steps in that direction by negotiating the agreements before the committee today. We strongly urge you and the committee to promptly approve each of these agreements, and we hope that subsequently the Senate's ratification will help Treasury negotiate similar agreements with many more countries.

We would also like to confirm to the committee our belief that it is worthwhile to negotiate for the inclusion of this provision even in treaties with countries whose domestic law already provides for a zero rate on dividends, such as the United Kingdom. Doing so has the effect of locking in the benefit of the zero rate, protecting U.S. parent companies from subsequent changes to the foreign tax regime.

The formal acceptance of the zero rate principle by treaty also serves as a valuable precedent, confirming to other prospective treaty partners the U.S. commitment to this policy.

These treaties are important to the U.S. business community because of the actual and precedential effect of eliminating the withholding tax on parent-subsidiary dividends, and because of several other benefits they introduce. For example, the U.K. treaty includes significant new provisions comparable to the U.S. model guaranteeing reciprocal recognition of each country's pension plans. That treaty also includes arrangements aimed at eliminating double taxation of income and gains from stock option plans. These provisions will eliminate substantial difficulties that would otherwise be faced by migratory employees as well as their employers.

In addition to its elimination of the withholding tax on parent-subsidiary dividends, the Australian protocol includes welcome deductions in the withholding tax rates on interest, royalties, and equipment rentals, bringing the rates closer to the U.S. model. The protocol to the U.S.-Mexico treaty includes an amendment that clarifies the ability of the U.S. taxpayer to treat income that may be taxed by Mexico under the treaty as having its source in Mexico so as to allow the U.S. resident a foreign tax credit for that Mexican tax. The zero rate on dividends paid to pension funds under the U.K. and Mexico agreements should attract investments from those funds into U.S. stocks.

We are particularly hopeful that the Senate will be able to complete its ratification procedures during the month of March so that instruments of ratification will be exchanged before April 1, 2003. This will prevent a year's delay in access to the U.K. treaty's relief from U.K. corporate tax under provisions such as the new pension rules, since that relief goes into effect only for financial years beginning on or after the April 1 immediately following the exchange of instruments of ratification.

As it has done in the past, the NFTC urges you to reject opposition to the treaty based on the presence or absence of a single provision, not that we know of any opposition in this case anyway. No process that is as laden with competing considerations as the negotiation of a full-scale tax treaty between sovereign States will be able to produce an agreement that will completely satisfy every possible constituency, and no such result should be expected.

On the whole, we applaud the U.S. negotiators for achieving agreements that reflect as well as these treaties do the positions of the U.S. model and the views expressed by the U.S. business community. The NFTC strongly supports the efforts of the IRS and the Treasury to promote continuing international consensus on the appropriate transfer pricing standards, as well as innovative procedures for implementing that consensus.

We applaud the continued growth of the APA program, which is designed to achieve agreement between taxpayers and revenue authorities on the proper pricing methodology to be used before disputes arise. We commend the IRS' ongoing efforts to refine and improve the operation of the competent authority process under treaties to make it a more efficient and reliable means of avoiding double taxation.

The NFTC also wants to reaffirm its support for the existing procedure by which Treasury consults on a regular basis with this committee, with the tax-writing committees, and the appropriate congressional staffs concerning treaty issues and negotiations, and the interaction between treaties and developing tax legislation. We encourage all participants in such consultations to give them a high priority.

We also respectfully encourage this committee to schedule tax treaties with a minimum of delay after receiving the agreements from the executive branch in order to enable improvements in the treaty networks to enter into effect as quickly as possible, precisely as you are doing in this case.

The NFTC also wishes to reaffirm its view, frequently voiced in the past, that Congress should avoid occasions of overriding by subsequent domestic legislation the U.S. treaty commitments that are approved by this committee. We believe that consultation and negotiation and mutual agreement upon changes, rather than unilateral legislative abrogation of treaty commitments, better supports the mutual goals of the treaty partners.

Finally, we are grateful to the chairman and the other members of the committee for giving international economic relations prominence in the committee's agenda, not only with respect to this issue, Mr. Chairman, but with respect to a number of other issues that have been placed on the full committee's agenda. We believe this is both important and welcome, and very impressive, particularly so soon after the new Congress, and when the demands on the committee's time in so many other areas are pressing.

We would also like to express our appreciation for the remarkable efforts of both the majority and the minority staffs which have allowed this hearing to be scheduled and held so efficiently. We respectfully urge the committee to proceed with ratification of these agreements as expeditiously as possible.

Thank you.

[The prepared statement of Mr. Reinsch follows:]

PREPARED STATEMENT OF HON. WILLIAM A. REINSCH, PRESIDENT, NATIONAL FOREIGN TRADE COUNCIL, INC.

Mr. Chairman and Members of the Committee:

The National Foreign Trade Council (NFTC) is pleased to recommend ratification of the treaty and protocols under consideration by the Committee today. We appreciate the Chairman's actions in scheduling this hearing so promptly, and we strongly urge the Committee to reaffirm the United States' historic opposition to double taxation by giving its full support to the pending treaty and protocols.

The National Foreign Trade Council, organized in 1914, is an association of some 350 U.S. business enterprises engaged in all aspects of international trade and investment. Our membership covers the full spectrum of industrial, commercial, financial, and service activities, and the NFTC therefore seeks to foster an environment in which U.S. companies can be dynamic and effective competitors in the international business arena. To achieve this goal, American businesses must be able to participate fully in business activities throughout the world, through the export of goods, services, technology, and entertainment, and through direct investment in facilities abroad. As global competition grows ever more intense, it is vital to the health of U.S. enterprises and to their continuing ability to contribute to the U.S. economy that they be free from excessive foreign taxes or double taxation that can serve as a barrier to full participation in the international marketplace. Tax treaties are a crucial component of the framework that is necessary to allow such balanced competition.

That is why the NFTC has long supported the expansion and strengthening of the U.S. tax treaty network and why we are here today to recommend ratification of the Tax Convention and Protocol with the United Kingdom and the Protocols amending the Tax Conventions with Australia and Mexico.

TAX TREATIES AND THEIR IMPORTANCE TO THE UNITED STATES

Tax treaties are bilateral agreements between the United States and foreign countries that serve to harmonize the tax systems of the two countries in respect of persons involved in cross-border investment and trade. In the absence of tax treaties, income from international transactions or investment may be subject to double taxation: once by the country where the income arises and again by the country of the income recipient's residence. Tax treaties eliminate this double taxation by allocating taxing jurisdiction over the income between the two countries.

In addition, the tax systems of most countries impose withholding taxes, frequently at high rates, on payments of dividends, interest, and royalties to foreigners, and treaties are the mechanism by which these taxes are lowered on a bilateral basis. If U.S. enterprises earning such income abroad cannot enjoy the reduced foreign withholding rates offered by a tax treaty, they are liable to suffer excessive and noncreditable levels of foreign tax and to be at a competitive disadvantage relative to traders and investors from other countries that do have such benefits. Thus, tax treaties serve to prevent this barrier to U.S. participation in international commerce.

Tax treaties also provide other features that are vital to the competitive position of U.S. businesses. For example, by prescribing internationally agreed thresholds for the imposition of taxation by foreign countries on inbound investment, and by requiring foreign tax laws to be applied in a nondiscriminatory manner to U.S. enterprises, treaties offer a significant measure of certainty to potential investors. Similarly, another extremely important benefit, which is available exclusively under tax treaties, is the mutual agreement procedure, a bilateral administrative mechanism for avoiding double taxation on cross-border transactions.

Taxpayers are not the only beneficiaries of tax treaties. Treaties protect the legitimate enforcement interests of the U.S. Treasury by providing for the exchange of information between tax authorities. Treaties have also provided a framework for the resolution of disputes with respect to overlapping claims by the respective governments, in particular, the practices of the Competent Authorities under the treaties have led to agreements, known as "Advance Pricing Agreements" or "APAs," through which tax authorities of the United States and other countries have been able to avoid costly and unproductive disputes over appropriate transfer prices for the trade in goods and services between related entities. APAs, which are agreements jointly entered into between one or more countries and particular taxpayers, have become common and increasingly popular procedures for countries and taxpayers to settle their transfer pricing issues in advance of dispute. The clear trend is that treaties are becoming an increasingly important tool used by tax authorities and taxpayers alike in striving for fairer and more efficient application of the tax laws.

Virtually all treaty relationships depend upon difficult and sometimes delicate negotiations aimed at resolving conflicts between the tax laws and policies of the negotiating countries. The resulting compromises always reflect a series of concessions by both countries from their preferred positions. Recognizing this, but also cognizant of the vital role tax treaties play in creating a level playing field for enterprises engaged in international commerce, the NFTC believes that treaties should be evaluated on the basis of their overall effect in encouraging international flows of trade and investment between the United States and the other country, in providing the guidance enterprises need in planning for the future, in providing nondiscriminatory treatment for U.S. traders and investors as compared to those of other countries, and in meeting a minimum level of acceptability in comparison with the preferred U.S. position and expressed goals of the business community. Slavish comparisons of a particular treaty's provisions with the U.S. Model or with treaties with other countries do not provide an appropriate basis for analyzing a treaty's value.

TREATIES BEFORE THE COMMITTEE TODAY

The treaty and protocols presently under consideration are a good illustration of the contribution such agreements can make to improving both the economic competitiveness of U.S. companies and the proper administration of U.S. tax laws in the international arena. For example, the U.K., Australian, and Mexican agreements contain a provision, new to U.S. treaty policy, which calls for a zero rate of withholding tax on dividends paid to parent corporations from their 80 percent or greater owned subsidiaries. The existence of a withholding tax on cross-border, parent-subsidiary dividends, even at the 5 percent rate previously typical in U.S. treaties, has served as a tariff-like barrier to cross-border investment flows. Without a zero rate, the combination of the underlying corporate tax and the withholding tax on the dividend will often lead to unusable excess foreign tax credits in the parent's hands, resulting in a lower return from a cross-border investment than a comparable domestic investment. This sort of multiple taxation of profits within a corporate group leads to exactly the kind of distortion in investment decisions that tax treaties are meant to prevent. If U.S. businesses are going to maintain a competitive position around the world, we need a treaty policy that protects us from multiple or excessive levels of foreign tax on our cross-border investments, particularly if our competitors already enjoy that advantage.

The United States has lagged behind other developed countries in eliminating this withholding tax and leveling the playing field for cross-border investment. For example, the European Union eliminated this tax on intra-EU, parent-subsidiary dividends over a decade ago, and dozens of bilateral treaties between foreign countries have also followed that route. The majority of OECD countries now have bilateral treaties in place that provide for a zero rate on parent-subsidiary dividends. The NFTC has for years urged Treasury to change U.S. treaty policy to allow for this zero rate on dividends, and we highly commend Treasury for taking the first steps in that direction by negotiating the U.K., Australian, and Mexican agreements before the Committee today. It is now up to this Committee to express its support for this important new development in U.S. treaty policy, and we strongly urge you to do that by your prompt approval of each of these agreements. We hope the Senate's ratification of these agreements will help Treasury negotiate similar agreements with many more countries.

We would also like to confirm to the Committee our belief that it is worthwhile to negotiate for the inclusion of this provision even in treaties with countries whose domestic law already provides for a zero rate on dividends, such as the United Kingdom. Doing so has the effect of locking in the benefit of the zero rate, protecting U.S. parent companies from subsequent changes to the foreign tax regime. The formal acceptance of the zero rate principle by treaty also serves as a valuable precedent, confirming to other prospective treaty partners the U.S. commitment to this policy. We would also note that the revenue implications of eliminating the U.S. withholding tax on dividends paid to U.K. parent companies is likely to be substantially affected by the corresponding elimination of the notional 5 percent U.K. withholding tax on dividends to U.S. parents under the current Treaty, thereby eliminating any U.S. obligation to give foreign tax credits for those amounts.

These treaties are important to the U.S. business community because of the actual and precedential effect of eliminating the withholding tax on parent-subsidiary dividends and because of several other benefits they introduce. For example, the U.K. Treaty includes significant new provisions, comparable to the U.S. Model, guaranteeing reciprocal recognition of each country's pension plans. That Treaty also includes arrangements aimed at eliminating double taxation of income and gains from stock option plans. These provisions will eliminate substantial difficulties that would otherwise be faced by migratory employees and by their employers as well. In addition to its elimination of the withholding tax on parent-subsidiary dividends, the Australian Protocol includes welcome reductions in the withholding tax rates on interest, royalties, and equipment rentals, bringing the rates closer to the U.S. Model. The Protocol to the U.S.-Mexico Treaty includes an amendment to the article on Relief from Double Taxation that clarifies the ability of a U.S. taxpayer to treat income that may be taxed by Mexico under the Treaty as having its source in Mexico, so as to allow the U.S. resident a foreign tax credit for that Mexican tax. The zero rate on dividends paid to pension funds under the U.K. and Mexican agreements should attract investment from those funds into U.S. stocks.

We are particularly hopeful that the Senate will be able to complete its ratification procedures during the month of March so that instruments of ratification will be exchanged before April 1, 2003. This will prevent a year's delay in access to the U.K. Treaty's relief from U.K. corporate tax under provisions such as the new pension rules, since that relief goes into effect only for financial years beginning on or after the April 1 immediately following the exchange of instruments of ratification.

These agreements also include important advantages for the administration of U.S. tax laws and the implementation of U.S. treaty policy. They all offer the possibility of administrative assistance between the relevant tax authorities. The agreements also include modern safeguards against treaty-shopping in accordance with U.S. policy. They reflect recent U.S. law changes aimed at preserving taxing jurisdiction over certain individuals who terminate their long-term residence within the United States. They also reflect modern U.S. treaty policy on when reduced U.S. withholding rates will apply to dividends paid by Regulated Investment Companies (RICs) and Real Estate investment Trusts (REITs). Finally, the U.K. Treaty includes targeted anti-abuse rules aimed at preventing inappropriate use of the benefits provided by the Treaty.

GENERAL COMMENTS ON TAX TREATY POLICY

As it has done in the past, the NFTC urges you to reject opposition to a treaty based on the presence or absence of a single provision. No process that is as laden with competing considerations as the negotiation of a full-scale tax treaty between sovereign states will be able to produce an agreement that will completely satisfy every possible constituency, and no such result should be expected. On the whole, the U.S. negotiators are to be applauded for achieving agreements that reflect as well as these treaties do the positions of the U.S. Model and the views expressed by the U.S. business community.

The NFTC also wishes to emphasize how important treaties are in creating, preserving, and implementing an international consensus on the desirability of avoiding double taxation, particularly with respect to transactions between related entities. The United States, together with many of its treaty partners, has worked long and hard through the OECD and other fora to promote acceptance of the arm's length standard for pricing transactions between related parties. The worldwide acceptance of this standard, which is reflected in the intricate treaty network covering the United States and dozens of other countries, is a tribute to governments' commitment to prevent conflicting income measurements from leading to double taxation and the resulting distortions and barriers for healthy international trade. Treaties are a crucial element in achieving this goal, because they contain an expression of both governments' commitment to the arm's length standard and provide the only available bilateral mechanism, the competent authority procedure, to resolve any disputes about the application of the standard in practice.

The NFTC recognizes that determination of the appropriate arm's length transfer price for the exchange of goods and services between related entities is sometimes a complex task that can lead to good faith disagreements between well-intentioned parties. Nevertheless, the points of international agreement on the governing principles far outnumber any points of disagreement. Indeed, after decades of close examination, governments around the world agree that the arm's length principle is the best available standard for determining the appropriate transfer price, because of both its economic neutrality and its ability to be applied by taxpayers and revenue authorities alike by reference to verifiable data.

The NFTC strongly supports the efforts of the lnternal Revenue Service and Treasury to promote continuing international consensus on the appropriate transfer pricing standards, as well as innovative procedures for implementing that consensus. We applaud the continued growth of the APA program, which is designed to achieve agreement between taxpayers and revenue authorities on the proper pricing methodology to be used, before disputes arise. We commend the Internal Revenue Service's ongoing efforts to refine and improve the operation of the competent authority process under treaties, to make it a more efficient and reliable means of avoiding double taxation.

The NFTC also wishes to reaffirm its support for the existing procedure by which Treasury consults on a regular basis with this Committee, the tax-writing Committees, and the appropriate Congressional staffs concerning treaty issues and negotiations and the interaction between treaties and developing tax legislation. We encourage all participants in such consultations to give them a high priority. We also respectfully encourage this Committee to schedule tax treaty hearings with a minimum of delay after receiving the agreements from the Executive Branch, in order to enable improvements in the treaty network to enter into effect as quickly as possible, as you are doing in this case.

The NFTC also wishes to reaffirm its view, frequently voiced in the past, that Congress should avoid occasions of overriding by subsequent domestic legislation the U.S. treaty commitments that are approved by this Committee. We believe that consultation, negotiation, and mutual agreement upon changes, rather than unilateral legislative abrogation of treaty commitments, better supports the mutual goals of treaty partners.

IN CONCLUSION

Finally, the Council is grateful to the Chairman and the Members of the Committee for giving international economic relations prominence in the Committee's agenda, particularly so soon in a new Congress, and when the demands upon the Committee's time are so pressing. We would also like to express our appreciation for the remarkable efforts of both Majority and Minority staff which have allowed this hearing to be scheduled and held in such a short period of time.

We respectfully urge the Committee to proceed with ratification of these agreements as expeditiously as possible.

Senator HAGEL. Mr. Reinsch, thank you. As always, helpful, and we are grateful you would take time to be with us. You were here over the last hour, and listened to the previous witnesses, their testimony and their response to questions and I would like to go back onto a couple of those tracks, because your perspective, the institutions that you represent, essentially the consumers of the structure that we are dealing with here, as always is critically important, and I would ask you the question that I asked Ms. Angus about the treaty that we are talking about today, the U.S.-U.K. treaty, on, from your perspective, framing that up as a model for other treaties as we negotiate those, realizing the variables and the dynamics are always a little different, but generally, and you alluded to this in your testimony, and I think your term was, generally your organization is supportive of what has been negotiated here.

Mr. REINSCH. I think my answer would be along the lines of Barbara's, Mr. Chairman. We are very much supportive of the treaty in general. There are some specific provisions that we would like to see incorporated in other treaties. Zero withholding is one, and I testified on that at some length, and I think pension rules are also an important innovation.

We are comfortable with the other parts of the treaty. As she noted, there are some aspects of the U.K. system that are, if not unique, at least different than other cases. In particular, with respect to the anti-conduit provisions that are here, I am not sure that we would want to say are entirely appropriate for either the U.S. model or for inclusion in every treaty.

As you may know, Mr. Chairman, we shared this committee's concern several years ago with much broader provisions that were proposed and then ultimately rejected by the committee, and we agreed with your action on that. These provisions do not raise those issues, and that is why we can support them in this treaty.

On the other hand, I think there are some characteristics of the U.K. system that may make the provisions in that treaty unique, and we would want to think a little bit about that before we would say that that should be added either as part of the model or included in other negotiations.

Senator HAGEL. Thank you. Also, another question that I posed to Ms. Angus, about—and I think Mr. Noren responded to this as well, from your perspective, some of the most significant barriers created by tax systems that you and your companies have to deal with, that maybe we are not getting at in these negotiations, or maybe we are.

Mr. REINSCH. She touched on two of them that I think are big ones, and I will elaborate a little bit on one. I think in general, the keeping-up problem is a serious one. We are in, as you well know from your other work, an ever more rapidly evolving global economic system. Things are changing very quickly, and simply keeping up with new systems, new relationships that are developed is a challenge; keeping up with new technologies is a challenge; and we certainly agree with Treasury's testimony that that is an issue that is very important as far as barriers are concerned.

The other one that I would particularly flag, because it relates so much to some other things that the NFTC is working on, is the issue of mobility, which Ms. Angus mentioned. One of the things that we have realized fairly recently is that mobility is becoming a competitiveness issue in the same way that market access and a whole bunch of other things are issues. Our companies, our members' companies in particular, are truly global companies, they operate everywhere, and they need to be able to move their personnel around in order to maximize the efficient allocation of their resources.

In the good old days we would talk about transferring people from the plant in Savannah to the plant in Omaha. Now we are talking—which I am sure it is something you would welcome—about transferring them from the plant in Shanghai to the plant in Los Angeles, or the research lab, more likely, or vice versa, and that raises a whole bunch of issues.

We are currently struggling, as you may know, with a whole bunch of visa issues and business travel issues that are the product of September 11 and policy changes that we have been unable to get the State Department and now the Department of Homeland Security to surmount, that prevent customers from coming to this country, that prevent people from coming to this country to take possession of things they have already bought, and prevent employees from coming to this country.

There are tax issues that become barriers, too, such as the sorting out or mutual recognition of pension rules, and the U.K. treaty is particularly important in this regard. As companies struggle to move their talented people where they need them, tax barriers and tax issues are going to become ever more important. Frankly, if somebody is going to take a huge bath if they move, that is a significant deterrent, and that, in turn, affects the company's competitiveness.

So I think you will be hearing—this is kind of an incipient—incipient is the wrong word, but this is a new issue for us, one that you are going to be hearing more from us about, but I think it has a place in the tax area as well, because frankly the incentives or barriers that different tax systems impose are significant obstacles to moving people around, and we want to get over that.

Finally on this, Mr. Chairman—I apologize for the long answer—we hear frequently from our members about particular glitches in particular countries that they would like to see corrected that would lend themselves to treaty negotiations. I would not want to go into that here. Let me see if we can provide you with some additional material after the fact, but they really are not issues that rise to the level of general principles, but particular problems that we have encountered in individual cases.

Senator HAGEL. Thank you. Do not concern yourself with long answers. It is just you and me.

Mr. REINSCH. There are all of them back there listening, too.

Senator HAGEL. Well, they do not have anything else to do. It is their bowling league night, obviously.

The provisions on the anti-treaty-shopping piece, how effective can these tools be, in your opinion? How effective should they be?

Mr. REINSCH. I was going to say, we will see. I think——

Senator HAGEL. That is a good answer. That is a senatorial answer.

Mr. REINSCH. Ms. Bennett thinks that they are tightly drafted and will be effective. My experience in other situations is, you know, this is a constant battle. For every door you close, someone tries to open another one somewhere else, another argument for periodic adjustments of the model and periodic negotiation. We support what has been done here, though, and we think they are tight and will be effective.

I will guarantee you that 3 or 4 years from now someone will have found something, some problem, and we will have to come back at them, but you can only learn those things by experience.

Senator HAGEL. So in your opinion they are worth the focus we are placing on them to see if we can use them as effective tools.

Mr. REINSCH. Yes.

Senator HAGEL. Something, obviously, that you mentioned, in general terms mentioned in Ms. Angus' testimony, the issue of the exemption for a limited class of individuals on these tax issues. She mentioned teachers and other specific categories, and I think the U.S.-U.K. treaty addresses some of that.

Would you like to expand on that a little bit from the perspective of, you just mentioned the competitiveness, obviously, of having the right people in the right places at the right time, the best people, and if we are not addressing some of those human dynamics in these treaties and protocols, then we are actually misplacing our emphasis here, and I would be interested in your perspective on that general universe of what we are trying to do in these tax treaties.

Mr. REINSCH. Well, I think this is an area that we are just beginning to look at in greater depth. We believe that the treaty addresses, by looking at the pension issues, the most important issue and the most important problem. There may be others, but I do not have anything else to offer for you on that right now, Mr. Chairman.

Senator HAGEL. Thank you. The general question that I posed to Ms. Angus and Mr. Noren, areas where we could be, should be more involved here, and I mentioned it a little earlier to you as well, as trying to get out ahead of some of these dynamics that we can anticipate, and you alluded to some extent to some of this in your reference to getting your customers into the country, and because of the security issue—and much of this is related to the September 11, 2001 terrorist attack, and much of our infrastructure, our government, our focus, our resources are appropriately on that issue, but there must be some balance and perspective applied to it as well.

It would be helpful to the committee for you to, if you care to, share any thoughts from your perspective, your vantagepoint from those you represent on this issue. You opened it up in some of the things you said, and I wanted to explore that a little more and give you a chance to develop that, if you wish, a little more.

Mr. REINSCH. Well, I am glad you did, because it is an opportunity, and I am glad to have the opportunity to take it. You have used the right word, Mr. Chairman, balance, and I think that is what we are looking for, the balance between security concerns and commercial necessities, for lack of a better term.

Some of this is human nature. If you look at the visa issue, frankly, part of this is, nobody wants to be the guy out in the embassy who stamps "approved" on the next terrorist visa. The result is, larger numbers of them get sent back here, they get thrown into the process, and, frankly, they get put into a process with a lot of people reviewing the applications whose mission is not a diplomatic, foreign policy, or a commercial mission. Their mission is a security mission, and from a security perspective, the way to achieve minimal risk is not to let anybody in.

As you well know from the export control debate, the way to achieve maximum safety there is not to let anything out, but we both know that those are not viable solutions, that economic considerations are important, particularly given the state of the economy here these days, and elsewhere, for that matter, and we have to try to strive for a balance in which we fully address our security needs, but do not do it in such a way that we are starting to put companies out of business here, and do not do it in such a way that we cause good friends of ours and allies to turn elsewhere not only for trade and commerce, but to send their students elsewhere, and things like that.

I mean, the long-term consequences of some of these things I believe are that we are going to break off relationships that we have spent generations building, and which frankly have been good for everybody. I mean, I think the views that you and I have shared in the past, Senator, is that this country gains enormously when foreigners come to this country, whether they are students, whether they are engineers who work here for 3 months, whether they are visitors, or whether they are immigrants.

We often get the best, and we often keep the best. They are not all the best, but net, this country has been built on immigrants. We have been built on different cultures and we are stronger for it. The ones who go back benefit us as well, because they take back some things from here, and we gain, and greater global understanding gains.

And I worry as a general matter that we are cutting some of those things off, and that over the long term, that is going to decrease understanding of who and why we are, which will complicate achieving our foreign policy goals among other things, and our security goals. And in the short run, there are very clearly commercial consequences that some companies, not for the record, but privately are able to quantify in lost sales, or lost income from training, from people who cannot come here.

Talk to the—well, do not do it today, but in 6 months, talk to the hotel people about the conferences that moved to Vancouver because the organizers were not sure they could get the paper presenters into San Francisco or Las Vegas or wherever the conference is in time. The richness of global dialog and discussion will be lost unless we address some of these things.

I think you can do that without compromising security. We are in the process of developing systems of access, too, that will help us get over these humps, and some of these problems are transition problems. One of the committee's tasks, I hope, will be to ensure that the transition is as short as possible, but some of the problems may be more fundamental than those, and I would urge you to look at those as well.

We really are moving into an era where the rapidity, the speed with which we can move money, move words through communication, move people through transportation is such that we simply have to keep our systems, our access systems and our mobility systems up to speed. It is the same old thing. You have got a global economy, and we are operating in a world of nation States, and your committee and your subcommittee are uniquely positioned to try to help lead everybody to see the problems that that causes and how we can accelerate some integrative factors in overcoming political barriers to allow economic growth to occur.

Senator HAGEL. Well, I am grateful for that answer, because it leads us to one inescapable conclusion, that America's competitiveness globally will determine our future, and if we allow that to erode by not paying attention to all the various components of positioning America in a continued high-ground position of being competitive, then we will have failed.

I think of what the Chairman of the Federal Reserve said before our Banking Committee a couple of weeks ago, when he was asked about tax cuts, and it does play right into what you are talking about. He talked about, what was critical in his opinion was a flexible economy. The tax cuts, certain tax cuts were good, he would support them, and you could argue it on a fairness basis, equity basis, more private capital in private hands, thus, investment and more productivity.

But his point was a fundamental point, and I think it cuts right the way you are talking about here and what we have been talking about. What is really the governing factor in these tax treaties is for us to stay competitive in the world for the future, that we are going to have to continue to keep a flexible economy, and exports trade is a huge part of that, and it becomes bigger and more important every day, which you understand about as well as anyone.

Well, Mr. Reinsch, as always, we are grateful to have you up here. On behalf of the committee I am going to instruct that we will keep the record open until close of business tomorrow for other Senators if they wish to present statements or they have questions for the committee, or for the Treasury.

And on your point, Bill, about hoping that this committee would move expeditiously on ratifying these protocols and treaty, I have been told that Chairman Lugar intends to get these up at our next business meeting. I think that will be next week, and we will push hard to complete that work at the business meeting, and if we can do that, then we can be in a position to have it ready for floor action.

Mr. REINSCH. That is wonderful news, Mr. Chairman.

Senator HAGEL. So, we will do everything we can. Any additional comments before we go to the next hearing?

Mr. REINSCH. No, sir.

Senator HAGEL. Thank you very much. We appreciate all of you learning as much as you have from Mr. Reinsch and our witnesses. The committee is recessed.

[Whereupon, at 4:20 p.m., the committee adjourned, to reconvene subject to the call of the Chair.]

ADDITIONAL QUESTIONS SUBMITTED FOR THE RECORD

RESPONSES OF THE TREASURY DEPARTMENT TO ADDITIONAL QUESTIONS FOR THE RECORD SUBMITTED BY SENATOR PAUL S. SARBANES

Question. How will this zero rate of withholding tax provided for dividends paid by a subsidiary in one treaty country to its 80 percent or greater parent in the other country affect our future tax treaties? How many upcoming treaties will include this provision? What would be the revenue impact if additional countries and the United States push for this inclusion? Will there be a new U.S. tax model treaty to reflect this change?

Treasury Department Response. The Treasury Department believes that the elimination by treaty of source-country withholding taxes on intercompany dividends, as is provided in the proposed treaty with the United Kingdom and the proposed protocols with Australia and Mexico now before the Committee, can serve to further the key objective of tax treaties to reduce barriers to cross-border trade and investment.

Historically, U.S. tax treaties have provided for limitations on source-country withholding taxes on direct investment dividends but have not provided for the elimination of such taxes. When this policy was consistent with general treaty practice throughout the world, the imposition of a limited withholding tax by the United States did not present a relative barrier to investing in the United States. However, in recent years more and more countries are eliminating withholding taxes on intercompany dividends through their bilateral tax treaties. In addition, the European Union has put in place a directive that eliminates all withholding taxes on dividends paid by a subsidiary in one EU member country to a parent in another EU member country. In the context of this changing environment, the Treasury Department believes it is in the United States' interest to consider, on a case by case basis, agreeing by treaty to eliminate source-country withholding taxes on certain intercompany dividends.

The proposed treaty with the United Kingdom and the proposed protocols with Australia and Mexico include provisions eliminating the source-country withholding tax on dividends received by a corporate parent from an 80-percent-owned subsidiary, provided that certain conditions are met. These conditions are intended to prevent third-country residents from being able to exploit these provisions in order to obtain reductions in U.S. tax to which they should not be entitled. A necessary prerequisite to any treaty provision eliminating withholding taxes on intercompany dividends is the inclusion in the treaty of effective anti-treaty-shopping rules and information exchange provisions that are sufficient to ensure that the benefits of these source-country tax reductions are provided only to *bona fide* residents of the treaty partners.

In every tax treaty negotiation, we must strike the appropriate balance of benefits in the allocation of taxing rights under the treaty. The agreed level of dividend withholding taxes is only one of the many elements that make up this balance. With respect to dividends in particular, we must consider the cross-border investment and dividend flows in each direction and the treaty partner's domestic law with respect to dividend withholding tax. We also must consider the potential benefits to be secured through locking in the treatment of dividends and providing stability regarding the future tax treatment of cross-border investment. We must consider the benefits inuring to the United States from other concessions the treaty partner may make. This analysis must be done in the context of each existing or potential new tax treaty relationship. We should not prejudge the outcome with any particular country or countries.

In considering the impact of any elimination of withholding taxes on intercompany dividends by treaty, it is appropriate to look to both the short-term effects on tax revenues and the longer-term economic implications of the overall tax treaty relationship. Because of the reciprocal nature of tax treaties, treaty reductions in source-country withholding taxes have offsetting effects on U.S. tax revenues in the short-term. Reductions in U.S. withholding tax imposed on dividends paid to foreign investors in the United States represent a short-term static reduction in U.S. tax revenues. Reductions in foreign withholding taxes imposed on dividends paid to U.S. investors abroad represent an increase in U.S. tax revenues due to the corresponding reduction in the foreign tax credits that otherwise would offset U.S. tax liability. Because of these offsetting effects, the overall revenue effect of tax treaties generally is viewed as negligible, with the estimated effects slightly positive or slightly negative in some particular cases.

Looking beyond the short-term effect on U.S. tax liabilities, an income tax treaty is a negotiated agreement under which both countries expect to be better off in the long run. These long-term economic benefits outweigh any net short-term static effects on tax liabilities. Securing the reduction or elimination of foreign dividend withholding taxes imposed on U.S. investors abroad can reduce their costs and improve their competitiveness in connection with international business opportunities. Reduction or elimination of the U.S. dividend withholding tax imposed on foreign investors in the United States may encourage inbound investment, and increased investment in the United States translates to more jobs, greater productivity and higher wage rates. The tax treaty as a whole creates greater certainty and provides a more stable environment for foreign investment. The agreed allocation of taxing rights between the two countries reduces cross-border impediments to the bilateral flow of capital, thereby allowing companies and individuals to more effectively locate their operations in such a way that their investments are as productive as possible. This increased productivity will benefit both countries' economies. The administrative provisions of the tax treaty provide for cooperation between the two countries, which will help reduce the costs of tax administration and improve tax compliance.

A flexible approach to the inclusion in tax treaties of provisions eliminating source-country withholding taxes on certain intercompany dividends is in order. In light of the range of factors that should be considered, the Treasury Department does not view this as a blanket change in the United States' tax treaty practice. Accordingly, we do not envision a change to the U.S. model tax treaty provisions relating to the allocation of taxing rights with respect to cross-border dividends. The optimal treatment of intercompany dividends should continue to be considered on a case-by-case basis in the context of each individual tax treaty relationship.

RESPONSE OF THE JOINT COMMITTEE ON TAXATION TO AN ADDITIONAL QUESTION FOR THE RECORD SUBMITTED BY SENATOR PAUL S. SARBANES

Question. In the draft report on the U.S.-U.K. treaty prepared by the Joint Committee on Taxation, there is language that reads: "the Committee may wish to note that adopting a zero-rate provision in the U.S.-U.K. tax treaty likely would result in a net revenue loss to the United States." In the Committee's final report, the language was changed to read: "the Committee may wish to note that adopting a zero-rate provision in the U.S.-U.K. tax treaty would have uncertain revenue effects for the United States."

What compelled the Committee to change the language?

Answer. This sentence in the Joint Committee staff's pamphlet on the proposed treaty was changed to reflect analysis appearing further in the relevant paragraph.[1] The revenue loss mentioned in the draft first sentence of the paragraph was a reference to the effect described in the second sentence of the paragraph (i.e., the loss of the 5-percent tax currently collected on dividends from U.S. subsidiaries to U.K. parent companies). The third and fourth sentences of the paragraph, which take into account reduced U.S. foreign tax credit claims resulting from a change to the treaty in connection with the U.K. advance corporation tax, as well as the final two sentences of the paragraph, which note the uncertain longer-term effects of the zero-rate provision on the domestic tax base, made it appropriate to amend the first sentence of the paragraph to read as published.

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[1] Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty Between the United States and the United Kingdom* (JCS-4-03), March 3, 2003, at 73-74.